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# THE MATTHEW EFFECT AND FEDERAL TAXATION

MARTIN J. McMAHON, JR.\*

*For whosoever hath, to him shall be given, and he shall have more abundance; But whosoever hath not, from him shall be taken away even that he hath.*

— Matthew 25:29

**Abstract:** The “Matthew Effect” is a synonym for the well-known colloquialism, “the rich get richer and the poor get poorer.” This Article is about the Matthew Effect in the distribution of incomes in the United States and the failure of the federal tax system to address the problem. There has been a strong Matthew Effect in incomes in the United States over the past few decades, with an increasing concentration of income and wealth in the top one percent. Nevertheless, there has been a continuing trend of enacting disproportionately large tax cuts for those at the top of the income pyramid. Neither economic theory nor empirical evidence supports the argument that these tax cuts increase incentives to save, invest, and work. A growing body of economic literature supports the thesis that economic inequality impedes economic growth instead of fostering it. Furthermore, in a modern industrialized democracy, most of what everyone earns is attributable to infrastructure created by society acting through government. Paradoxically, public concern with increasing economic inequality is not matched by opposition to tax legislation that delivers vastly disproportionate benefits to the super-rich. This Article suggests that future tax legislation ought to mitigate the Matthew Effect rather than enhance it.

## INTRODUCTION

The term, the “Matthew Effect,” was coined by sociologist Robert K. Merton in 1968 based on the passage from the Gospel of Matthew

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in the epigram.<sup>1</sup> "Put in less stately language, the Matthew Effect consists in the accruing of greater increments of recognition for particular scientific contributions to scientists of considerable repute and the withholding of such recognition from scientists who have not yet made their mark."<sup>2</sup> The Matthew Effect is not limited to the context in which Robert Merton first coined it. More generally, it is a synonym for the well-known colloquial aphorism, "The rich get richer and the poor get poorer." This Article is about the Matthew Effect in the distribution of incomes in the United States and the failure of the federal tax system to address the Matthew Effect.

Over twenty years ago, economist Paul Samuelson observed, "If we made an income pyramid out of a child's blocks, with each layer portraying \$1000 of income, the peak would be far higher than the Eiffel Tower, but most of us would be within a yard of the ground."<sup>3</sup> Things have changed a lot since then, and things have changed little since then. The peak is higher, but most people are still in essentially the same place. During the last two decades of the twentieth century, the distribution of incomes and wealth in the United States reached levels of inequality that have not been seen since the Roaring Twenties. Although the "Roaring Nineties," as the decade was labeled by Joseph E. Stiglitz, might have been "the world's most prosperous decade,"<sup>4</sup> the prosperity was not spread around. The data indicate that a very small number of people garnered an overwhelming amount of the increase in incomes and wealth in that decade, as well as in the prior decade.

Between 1947 and 1997, median family income (in constant dollars) grew by 122%.<sup>5</sup> Ninety-one percent of this growth, however, occurred before 1970. Between 1979 and 1997, average household before-tax income grew by nearly one-third in real terms, but that growth was shared unevenly across the income distribution. Average income for households in the top quintile rose by more than one-half, while average income for the middle quintile increased by only 10%

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<sup>1</sup> See *Matthew* 25:29; Robert K. Merton, *The Matthew Effect in Science*, 159 *SCIENCE* 56, 58 (1968).

<sup>2</sup> Merton, *supra* note 1, at 58.

<sup>3</sup> PAUL SAMUELSON, *ECONOMICS* 80 (11th ed. 1980).

<sup>4</sup> JOSEPH E. STIGLITZ, *THE ROARING NINETIES* (2003) (referencing cover).

<sup>5</sup> Daniel H. Weinberg et al., *Fifty Years of U.S. Income Data from the Current Population Survey: Alternatives, Trends, and Quality*, 89 *AM. ECON. REV.* 18, 20 (1999) (indicating growth in the median family income from \$20,102 to \$44,368 (in 1997 dollars)).

and average income for the lowest quintile decreased slightly.<sup>6</sup> Income growth at the very top of the distribution was even greater. Average before-tax income in 1997 dollars for the top 1% of households more than doubled, rising from \$420,000 in 1979 to more than \$1 million in 1997. Inequality continued to increase in the late-1990s.<sup>7</sup>

During the 1950s and 1960s, family income inequality decreased, but the tide changed after 1969, and through the last three decades of the twentieth century income inequality increased.<sup>8</sup> Nevertheless, the federal tax system did little to ameliorate the increasing economic inequality. Prior to 1982, high marginal rates at the top had some redistributive effects. Redistributive effects were reduced as a result of the rate reductions in the Economic Recovery Act of 1981 (the "1981 Act"), and after the Tax Reform Act of 1986 (the "1986 Act"), the redistributive effect of the income tax was relatively low.<sup>9</sup> Adoption of the 39.6% bracket in 1993 increased the redistributive effects of the income tax, but redistribution decreased again as a result of the reduction in capital gains rates in 1997. As of 2000, the redistributive effect of the income tax was somewhat less than it was in the early 1980s, although it was somewhat greater than it was in the early 1990s.<sup>10</sup> As we move into the new millennium, however, recent changes in the federal tax system pre-empt a decreasing role not only in redistribution, but in mitigation of vast disparities in income and wealth. Since the inauguration of the Bush Administration<sup>11</sup> in 2000, there have been three major tax acts, which have reduced significantly the tax burden of the super-rich, while handing out small change to everyone else.

Part I of this Article examines in detail the increasing concentration of income and wealth in the top 1%, and particularly within much narrower cohorts near the top of the top 1%, that has occurred

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<sup>6</sup> CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES, 1979–1997, at 6, 7 & fig.1-5 (2001), available at <http://www.cbo.gov/ftpdocs/30xx/doc3089/EffectiveTaxRate.pdf> (last modified Nov. 13, 2001).

<sup>7</sup> See *id.* at 10, 11, 170–71 app. J. Although the Congressional Budget Office did not include comprehensive data for years after 1997, the study states that the rapid rise in the share of income going to the top of the distribution continued at least into 1998 and 1999. See *id.*

<sup>8</sup> See Weinberg et al., *supra* note 5, at 21.

<sup>9</sup> Thomas B. Petska et al., *New Estimates of the Distribution of Individual Income and Taxes*, in 2002 PROCEEDINGS OF THE 95TH ANNUAL NATIONAL TAX ASSOCIATION CONFERENCE ON TAXATION 342, 350 (2003).

<sup>10</sup> *Id.* at 349.

<sup>11</sup> All references to the "Administration" or the "Bush Administration" are to the George W. Bush Administration unless otherwise indicated.

over the past twenty-five years.<sup>12</sup> This Part demonstrates the strong Matthew Effect in incomes in the United States over that period. The super-rich are pulling away from everyone by so much and at a rate so fast that the fact that incomes of many households at the bottom and in the middle have stagnated, or even fallen in constant dollars, has been obscured by ever increasing per capita income—a false talisman of progress because it obscures distributional issues.

Part II discusses the distribution of after-tax income and wealth in the United States in recent years.<sup>13</sup> Wealth and income levels are highly correlated. This Part describes the increasing disparity in after-tax incomes, particularly the rate at which the amount and share of total after-tax income of the top 0.5%, and even of smaller cohorts further toward the top of the income pyramid, are growing relative to everyone else. Moreover, the share of wealth owned by the super-rich is growing even faster than its share of income. This Part demonstrates that the federal tax system has failed to respond adequately to take into account ever increasing income inequality.

Part III examines changing effective federal tax rates over the last two decades of the twentieth century, examining with more precision the aspects of the federal tax system that have failed to respond adequately to ever increasing income inequality.<sup>14</sup> After first discussing the various major legislative changes in this period, the Part then examines the shifting burdens, measured by effective tax rates on different income cohorts, of the various federal taxes individually and collectively. Part IV then reviews the economic literature on the effect of these changes on the progressivity of the tax system. It concludes that by the close of the twentieth century the tax system was not raising revenue as fairly and was doing less to mitigate inequality than it had in the middle of that century.

Part V describes the Republican tax policy agenda for the new millennium, as embodied in tax legislation enacted in 2001 through 2003 and discusses the projected distribution of the benefits of the massive tax cuts enacted in that brief period.<sup>15</sup> The projections show that the tax cuts disproportionately favor those at the top of the income pyramid with very small tax cuts going to everyone else, even the upper middle class and the merely rich, in contrast to the super-rich.

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<sup>12</sup> See *infra* notes 20–75 and accompanying text.

<sup>13</sup> See *infra* notes 76–208 and accompanying text.

<sup>14</sup> See *infra* notes 109–204 and accompanying text.

<sup>15</sup> See *infra* notes 321–460 and accompanying text.

Part VI deals with economic issues.<sup>16</sup> It starts by demonstrating that theory does not support the argument that the tax cuts were necessary to spur incentives to save, invest, and work, and that the empirical evidence of the effect of tax cuts on savings and investment clearly contradicts the claims made by supporters of the tax cuts. Next, this Part examines the rapidly growing body of economic literature supporting the thesis that economic inequality impedes, rather than fosters, economic growth. Thus, not only do the tax cuts not spur economic growth, but because they increase inequality, they probably impede economic growth. This Part then examines empirical data that debunk the notion that “a rising tide lifts all boats,” by demonstrating that increasing incomes for the few and decreasing incomes for the many can occur even though the economy is “growing,” that is, the national GDP is increasing. Distribution thus counts. Finally, the Part briefly notes the disastrous long-term economic effects of the massive federal budget deficits largely attributable to the Bush tax cuts.

Part VII discusses the philosophical basis for a highly redistributive tax system, arguing that in a modern industrialized democracy, most of what everyone earns is attributable to infrastructure created by society acting as a whole, principally through government.<sup>17</sup> It rejects the notion that individuals have the first claim to everything that they earn, and although it does not label it as such, adopts a more communitarian approach.<sup>18</sup> This Part then briefly discusses the deleterious effect of increasing concentrations of wealth on the future health of democratic institutions.

Part VIII examines the paradox of public concern with increasing economic inequality, thinking it undesirable, while simultaneously supporting tax cut legislation that in fact delivers vastly disproportionate benefits to the very wealthy—the super-rich.<sup>19</sup>

The Conclusion suggests that it is time for the tax system to address these problems by substantially increasing progressivity at the top of the income pyramid. Marginal tax rates should be increased for incomes in excess of \$500,000, and as incomes increase to progres-

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<sup>16</sup> See *infra* notes 461–521 and accompanying text.

<sup>17</sup> See *infra* notes 522–562 and accompanying text.

<sup>18</sup> See Richard M. Coughlin, *Whose Morality? Which Community? What Interest? Socio-Economic and Communitarian Perspectives*, 25 J. SOCIO-ECON. 135, 143 (1996) (arguing that communitarianism balances individual rights and individual responsibilities). For more information on communitarianism generally, see AMITAI ETZIONI, *THE SPIRIT OF COMMUNITY: RIGHTS, RESPONSIBILITIES AND THE COMMUNITARIAN AGENDA* 261 (1993).

<sup>19</sup> See *infra* notes 563–577 and accompanying text.

sively higher levels, additional rate brackets should be added to impose substantially higher marginal rates on incomes in excess of \$1 million and particularly on incomes that exceed \$5 million. Future tax legislation ought to mitigate the Matthew Effect rather than enhance it.

## I. THE DISTRIBUTION OF BEFORE-TAX INCOME

F. Scott Fitzgerald was right when he had a character quip, "Let me tell you about the very rich. They are different from you and me."<sup>20</sup> Both income and wealth in the United States are highly concentrated in a very small percentage of the population, and wealth is somewhat more concentrated than income. Although the data from various sources often use slightly different measures of the relevant unit and the precise measurement of income or wealth, the pattern is consistent. One percent or less of the population is remarkably different than everyone else. Compared to everyone below them, the top 1% are in a class by themselves. But that is not all. Although the data are not as complete for subgroups within the top 1%, there are enough data to indicate that even the top 1% is not a homogenous group. The *crème de la crème*—the top 0.01%, or even smaller subgroups—have so much income and wealth that these groups merit separate consideration in any analysis.

There are several methods for comparing income distributions, including actual money incomes for different income classes, incomes for different groups with reference to an index number, for example, as a multiple of the poverty rate, household income ratios, the percentage of national income received by different income classes, and the Gini index.<sup>21</sup> These are all valid measures of income inequality

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<sup>20</sup> F. SCOTT FITZGERALD, *The Rich Boy* (1926), reprinted in *THE SHORT STORIES OF F. SCOTT FITZGERALD* 318 (Matthew J. Bruccoli ed., 1989).

<sup>21</sup> See U.S. CENSUS BUREAU, *HISTORICAL INCOME INEQUALITY TABLES*, <http://www.census.gov/hhes/income/histinc/ineqtc.html> (last revised May 13, 2004). See generally ARTHUR F. JONES & DANIEL F. WEINBERG, U.S. CENSUS BUREAU, PUB. NO. P60-204, *THE CHANGING SHAPE OF THE NATION'S INCOME DISTRIBUTION, 1947-1988* (June 2000), available at <http://www.census.gov/prod/2000pubs/p60-204.pdf> (last modified Aug. 24, 2000).

On the Gini index, a measure of zero is absolute equality and a measure of one is the maximum inequality. Changes in the Gini index over time, or as a result of a government policy, for example, the tax structure, indicate the direction and magnitude of changes in the distribution of incomes. The Census Bureau calculates and publishes detailed Gini indices using a variety of definitions of income. For further discussion of the Gini index, see *infra* notes 197-200 and accompanying text.

and changes in income inequality.<sup>22</sup> A wealth of data is available on income distributions, and it reveals very unequal distributions no matter which method is chosen.

### A. *The Rich Are Getting Richer*

#### 1. The “Merely Rich” Are Running Away from the Pack

Recent data from the Congressional Budget Office (the “CBO”) provide the best perspective on the phenomenal growth of the income of those households in the highest income cohorts and the ever increasing income inequality over the past two decades. Other data are available from the Census Bureau and the Internal Revenue Service (the “IRS”), but the CBO data provide the more comprehensive perspective.<sup>23</sup> Although the Census Bureau data are available for a number of definitions of income, they do not generally include capital gains and do not adequately break out those households within cohorts smaller than the top 5%.<sup>24</sup> IRS data, which are based primarily on adjusted gross income (the “AGI”) shown on tax returns, do not adequately reflect economic income, do not consistently identify the top 1% and top 5% cohorts, and are available with respect to taxpayers rather than households. One important piece of information from the Census Bureau data, however, is that between 1979 and 2001, the income ratios—the multiple of the average income of the lower percentile that is the average income of the higher percentile—for every income percentile above the fiftieth percentile increased relative to lower income percentiles, whereas the income ratio of the tenth to

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<sup>22</sup> See generally DANIEL H. WEINBERG, U.S. CENSUS BUREAU, PUB. NO. P60-191, CURRENT POPULATION REPORTS: A BRIEF LOOK AT POSTWAR U.S. INCOME INEQUALITY (1996), available at <http://www.census.gov/prod/1/pop/p60-191.pdf> (last modified Feb. 26, 1997).

<sup>23</sup> The CBO analysis is based on an adjusted pre-tax comprehensive household income measure that includes all cash income (both taxable and tax-exempt), taxes paid by businesses (which are imputed to individuals on the basis of assumptions about incidence), employee contributions to 401(k) retirement plans, and the value of income received in kind from various sources (including employer-paid health insurance premiums, Medicare and Medicaid benefits, and food stamps, among others). The CBO also adjusted household comprehensive income for differences in household size. CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES, 1997 TO 2000, at 3–4 (2003), available at <http://www.cbo.gov/ftpdocs/45xx/doc4514/08-29-Report.pdf>.

<sup>24</sup> See CONG. BUDGET OFFICE, *supra* note 6, at 67–68 app. F; Petska et al., *supra* note 9, at 342.



fiftieth percentile was the same in 2001 as it was in 1980.<sup>25</sup> The data thus demonstrate that although those in the middle of the income distribution did not gain relative to the poor, the households in the top half pulled away from households below them. Furthermore, within that top half, households relatively higher in the income distribution pulled away from households relatively lower in the income distribution at an increasing rate.

The most recent CBO data show not only that the income inequality inexorably increased throughout the last two decades of the twentieth century, but that income inequality—particularly with respect to the rate at which those at the very top of the income pyramid pulled away from everyone else—increased in the 1990s more than in the 1980s.<sup>26</sup> In 2000, before-tax income was more concentrated in the top 1% than at any time since 1929.<sup>27</sup> The increasing income disparities between the top 40% and the bottom 60% between 1979 and 1993 was attributable to the combination of a *decline* in real income of the bottom 40% and stagnation of the income of the middle quintile, coupled with modest income growth for the fourth quintile and significant income growth for the top quintile, particularly for the higher cohorts within the top quintile. From 1993 to 2000, the three lowest quintiles experienced a not insignificant increase in real incomes. Nevertheless, due to dramatic increases in their incomes, the upper income quintiles—particularly the top 10%—actually pulled away from the lower income quintiles at a much greater rate in the mid-to-late 1990s than they did in the period from 1979 to 1993, as is demonstrated in the following table.

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<sup>25</sup> See U.S. CENSUS BUREAU, *Household Income Ratios by Selected Percentile: 1967 to 2001*, in HISTORICAL INCOME TABLES tbl.IE-5 (2004), <http://www.census.gov/hhes/income/histinc/ie5.html> (last revised May 13, 2004).

<sup>26</sup> Some studies acknowledge that income disparities grew sharply in the 1980s, but assert that growth of income disparities then stabilized in the 1990s. See, e.g., Weinberg et al., *supra* note 5, at 18. These conclusions are based on Census Bureau data that appear to show that income disparities have remained relatively constant since 1993. For a number of reasons, those Census Bureau data fail to capture much of the income growth that has occurred at the top of the income distribution in the 1990s. See JONES & WEINBERG, *supra* note 21, at 7–9 (Census Bureau studies and the Gini index show that most of the significant increases in income inequality developed between 1981 and 1992 and that increasing income inequality abated during the 1990s). The data from the CBO and IRS Statistics of Income Division clearly refute this conclusion.

<sup>27</sup> See generally ROBERT GREENSTEIN & ISAAC SHAPIRO, CTR. ON BUDGET & POLICY PRIORITIES, *THE NEW DEFINITIVE CBO DATA ON INCOME AND TAX TRENDS* (Sept. 23, 2003), available at <http://www.cbpp.org/9-23-03tax.pdf>.

Average Pre-Tax Income (2000 Dollars) <sup>28</sup>						
				Percent Change <sup>29</sup>		
Group	1979	1993	2000	1979–1993	1993–2000	1979–2000
1st Quintile	13,700	13,500	14,600	-1.46	8.15	6.57
2d Quintile	29,800	29,400	33,300	-1.34	13.27	11.74
3d Quintile	44,700	45,300	50,300	1.34	11.04	12.53
4th Quintile	60,500	64,700	74,500	6.94	15.15	23.14
5th Quintile	115,800	141,300	196,500	22.02	39.07	69.69
All	52,300	59,100	74,100	13.00	25.38	41.68
Top 10%	151,000	192,200	286,300	27.28	48.96	89.60
Top 5%	205,500	268,900	434,300	30.85	61.51	111.34
Top 1%	454,200	671,000	1,290,800	47.73	92.37	184.19

This table vividly demonstrates that the real incomes of the top cohorts—the top 5% and the top 1%—grew dramatically more than did the incomes of all of the other cohorts.<sup>30</sup> The top 5% saw its average income increase at nearly nine times the rate of increase for the mid-

<sup>28</sup> CONG. BUDGET OFFICE, *supra* note 23, at 30–31 app. B, tbl.B1-C.

<sup>29</sup> *Id.* (calculations made by author based on these figures).

<sup>30</sup> The Census Bureau data are slightly different, but do not paint a contrary view.

Mean Household Before-Tax Income (2001 Dollars)			
Group	1979	2000	2001
1st Quintile	9295	10,440	10,136
2d Quintile	22,642	26,069	25,468
3d Quintile	37,269	43,412	42,629
4th Quintile	54,662	67,485	66,839
5th Quintile	97,133	146,240	145,970
Top 5%	145,048	259,445	260,464

U.S. CENSUS BUREAU, *Mean Income Received by Each Fifth and Top 5 Percent of Households (All Races): 1967 to 2001*, in HISTORICAL INCOME TABLES tbl.H-3 (2004), <http://www.census.gov/hhes/income/histinc/h03.html> (last revised July 8, 2004). Census Bureau data include only money income (including public assistance and food stamps, but excluding capital gains) before taxes; they do not reflect in kind receipts or fringe benefits. Weinberg et al., *supra* note 5, at 18. These data, which are based on surveys, under-report capital income, such as interest and dividends, although wage income is well reported. *Id.* at 19.

For another analysis of the change in average household net incomes, see CHRIS HARTMAN, INEQUALITY.ORG, FACTS AND FIGURES, PART 2: INCOME PATTERNS, CHANGE IN FAMILY INCOME, 1947–79 AND 1979–2001 fig.2.1, <http://inequality.org/facts3fr.html> (last updated Oct. 8, 2002) (citing U.S. CENSUS BUREAU, *Mean Income Received by Each Fifth and Top 5 Percent of Families (All Races): 1966 to 2001*, in HISTORICAL INCOME TABLES tbl.F-3, <http://www.census.gov/hhes/income/histinc/f03.html>). (The constant dollar mean increase is in constant 2001 dollars.)

	Bottom 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%	Top 5%
1947–1979	+116%	+100%	+111%	+114%	+99%	+86%
1979–2001	+3%	+11%	+17%	+26%	+53%	+81%

dle quintile and at nearly five times the rate of increase for the fourth quintile. The top 1% saw its average income increase at nearly fifteen times the rate of increase for the middle quintile and at nearly eight times the rate of increase for the fourth quintile. The bottom 60% saw two decades of nearly stagnant or very modest real income growth.<sup>31</sup>

Nevertheless, the manner in which the CBO data are presented masks the real disparity between the top 1% and the remainder of the top 5% and top 10%. Because the average income grows at an increasing rate, the averages for large cohorts, including the top 1%, are distorted. The data more accurately present the true picture if they are recalculated separately to state the average pre-tax income of the 81st to 90th percentiles, the 91st to 99th percentiles, and the top 1%.

Average Pre-Tax Income (2000 Dollars) <sup>32</sup>				Percent Change		
Group	1979	1993	2000	1979-1993	1993-2000	1979-2000
81st-90th %	\$78,427	\$90,400	\$103,435	15.25	14.42	31.89
91st-95th %	\$96,500	\$115,500	\$138,300	19.69	19.74	43.32
96th-99th %	\$143,955	\$168,375	\$229,485	16.96	36.29	59.41
Top 1%	\$454,200	\$671,000	\$1,290,800	47.73	92.37	184.19

The data in this table clearly illustrate that the top 20% is not a group that can be lumped together meaningfully when discussing income distribution and the role of taxes in effecting redistribution. The average income of the 81st through 90th percentiles is closer to the average income of the fourth quintile than it is to the average income of the 91st through 95th percentiles. Even the average income of the 91st through 95th percentiles is closer to the average income of the fourth quintile than it is to the average income of the 96th through 99th percentiles. And the average income of the 96th through 99th percentiles, although not even twice the average income of the 91st through 95th percentiles is dwarfed by the average income of the top

<sup>31</sup> Three years earlier, the CBO had concluded that the average income for households in the lowest fifth had dropped slightly from 1979 to 1997. CONG. BUDGET OFFICE, *supra* note 6, at 7. The baseline data for the CBO study of 1997 through 2000, however, present a significantly different picture, showing an increase in average real income for that cohort from \$13,500 in 1979 to \$14,200 in 1997 (in 2000 dollars). CONG. BUDGET OFFICE, *supra* note 23, at 30-31 tbl.B1-C. For further analysis of these data, see ISAAC SHAPIRO ET AL., CTR. OF BUDGET & POLICY PRIORITIES, PATHBREAKING CBO STUDY SHOWS DRAMATIC INCREASES IN INCOME DISPARITIES IN 1980s AND 1990s: AN ANALYSIS OF THE CBO DATA (May 31, 2001), available at <http://www.cbpp.org/5-31-01tax.pdf>.

<sup>32</sup> Calculations made by author based on information derived from CONG. BUDGET OFFICE, *supra* note 23, at 30-31 app. B tbl.B1-C.

1%. More significantly, the top 1% saw its average income *increase* at six times the rate of increase for the 81st through 90th percentiles and at more than three times the rate of increase for the 96th through 99th percentiles. The top 1% is leaving everyone else in the dust.

## 2. The "Super-Rich" Are Soaring Above the Merely Rich

Just as the aggregate data for the top quintile hide the extraordinary differences between the top 1% and the remainder of the cohort, the aggregate data for the top 1% hide extraordinary differences within that select group. Data for smaller cohorts within the top 1% are difficult to obtain, and when they are available they often are based on different income measures, different statistical descriptions, and a different base year for measuring changes in constant dollars. The preceding data—mostly CBO data—were based on an expanded income concept and described mean income for the respective cohorts. Another measure of differences between income classes is the threshold income for each income cohort. The greater the difference between the threshold income necessary to be included in the cohort and the average income of the cohort, the greater the income inequality within the cohort itself. The threshold incomes necessary to enter each quintile, and smaller cohorts within the top quintile in 1979 and 2000, using a comprehensive money income calculation starting from AGI (including capital gains, but excluding in-kind receipts), measured in constant 1982 through 1984 dollars, were as follows:<sup>33</sup>

Threshold Incomes for Selected Income Cohorts (Constant 1982–1984 Dollars)			
Group	1979	1993	2000
Top 80%	\$6441	\$5388	\$5923
Top 60%	\$12,887	\$11,159	\$12,233
Top 40%	\$21,654	\$19,136	\$20,914
Top 20 %	\$34,051	\$32,669	\$36,847
Top 10%	\$44,884	\$40,044	\$54,422
Top 5%	\$56,704	\$61,674	\$77,894
Top 1%	\$109,751	\$137,992	\$205,595
Top 0.5%	\$150,322	\$208,381	\$321,913
Top 0.25%	\$206,821	\$311,239	\$523,994
Top 0.1%	\$321,679	\$525,542	\$985,088

According to these data, between 1979 and 2000, the threshold to climb out of the bottom 60% fell in real dollars, meaning that this

<sup>33</sup> Petska et al., *supra* note 9, at 353 tbl.2 (2003).

group would have fallen in relative terms even if the top of the income pyramid had no increase in real income. But the top 20% realized increasing real incomes. Even the threshold for the top 20% increased by only 8.2% in real terms. At the same time, the thresholds for the top 1% and top 0.5% roughly doubled, which is significantly more than the increase in thresholds for the top 10% and top 5%. The threshold for the top 0.25% increased by 153%, and the threshold for the top 0.1% roughly tripled, indicating that the super-rich are pulling away from the nearly super-rich at an astonishing rate.<sup>34</sup>

The increasingly elite status of the super-rich can be put in the perspective of the earlier CBO data by examining the thresholds for entry into the top cohorts in current 2000 dollars, which facilitates a comparison with the CBO data on average incomes. According to the CBO data, the average income of the top 1% in 2000 was \$1,290,800. The threshold for entering the top 1%—albeit using a different, less comprehensive, income definition based on IRS data—was \$354,035.<sup>35</sup> The threshold for the top 0.5% was \$554,335; for the top 0.25%, it was \$902,317, and for the elite top 0.10%, it was \$1,696,322.<sup>36</sup> Within the top 1%, so much of the income was concentrated in the top 0.10% that even those at the threshold for the top 0.25% had an income of roughly only two-thirds of the average for the top 1%.<sup>37</sup>

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<sup>34</sup> Another way to look at these data is to calculate the threshold for each income cohort as a multiple of the income threshold for the prior cohort.

Income Thresholds as a Multiple of the Income Threshold for the Prior Income Cohort			
Group	1979	1993	2000
Top 80%	—	—	—
Top 60%	2.08	2.07	2.06
Top 40%	1.68	1.71	1.71
Top 20 %	1.57	1.71	1.76
Top 10%	1.32	1.41	1.48
Top 5%	1.26	1.34	1.43
Top 1%	1.94	2.24	2.64
Top 0.5%	1.37	1.51	1.57
Top .25%	1.38	1.49	1.63
Top 0.1%	1.56	1.69	1.88

These data even more clearly reveal that although income inequality within the middle quintiles has remained relatively constant, inequality among the upper cohorts within the top 1% is increasing.

<sup>35</sup> Petska et al., *supra* note 9, at 352 tbl.1.

<sup>36</sup> *Id.*

<sup>37</sup> Similar conclusions were found in James Alm & Sally Wallace, *Are the Rich Different?*, in *DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 165, 178 tbl.6.5 (Joel B. Slemrod ed., 2000). James Alm and Sally Wallace estimated that in 1989 the top 1%

The story of super-elites does not stop with the top 0.10%. Within the top 0.10% is another ultra-elite, dubbed the "Fortunate 400."<sup>38</sup> Based on IRS data, in 2000, the threshold income for joining this group, constituting the top 0.00031% of tax returns, was an AGI of \$86.8 million, and the average AGI was \$173.9 million.<sup>39</sup> To qualify for this group requires an income more than fifty times the threshold income for joining the top 0.10%. This jump within a cohort of less than 0.10% exceeds the gap between the credentials for entering the top one-tenth of 1% and entering the top 40%—the \$1,696,322 annual income necessary to join the top 0.10% was forty-seven times more than the \$36,014 annual income necessary to join the top 40% in 2000.

The Fortunate 400, however, is a fluid group that changes significantly from year to year—over the nine years from 1992 through 2000, a total of 3600 returns were identified as belonging to this group, with fewer than 25% of taxpayers within this group appearing twice and fewer than 13% appearing more than twice. Furthermore, incomes of the members of this club consist largely of capital gains—over 70% of the group's total AGI in each of 1998, 1999, and 2000 was net capital gains.<sup>40</sup> Nevertheless, it is worth noting that if the lowest income member of this elite group, with an income of \$86.8 million, realized the group's average percentage of AGI as capital gains in 2000, that taxpayer's capital gains would have been nearly \$62 million. If that were averaged over even a thirty-year holding period, annual income from capital gains alone would have exceeded \$2 million in 2000 constant dollars, which would have put the taxpayer substantially above the threshold for the top 0.10% in every year.<sup>41</sup> Thus, even the lumpiness of capital gains realizations does not affect the status of members of this

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had 14.39% of all income, but individuals in the top 0.5% had 10.96% of the income. Thus, the top 0.5% received over 75% of the income of the top 1%. That pattern was repeated in 1994, when individuals in the top 1% had 13.73% of all income, but those in the top half of 1% received 10.47% of all income.

<sup>38</sup> See generally Joel Slemrod, *The Fortunate 400*, 100 TAX NOTES 935 (2003); Martin A. Sullivan, *The Rich Get Soaked While the Super Rich Slide*, 101 TAX NOTES 581 (2003).

<sup>39</sup> Michael Parisi & Michael Strudler, Internal Revenue Serv., *The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992–2000*, 23 STATISTICS OF INCOME BULL. 10, 11–12 (Spring 2003), available at <http://www.irs.gov/pub/irs-soi/00in400h.pdf>.

<sup>40</sup> *Id.* at 11. This is a dramatic increase. In earlier years the percentage of the group's AGI represented by net capital gains was lower, sometimes much lower: in 1992, it was 36.08%; in 1993, it was 48.01%; in 1994, it was 52.26%; in 1995, it was 44.10%; in 1996, it was 63.40%; and in 1997, it was 72.91%. *Id.*

<sup>41</sup> For thresholds for the top 0.1% in current dollars, see Petska et al., *supra* note 9, at 352 tbl.1.

ultra-elite group as members of the super-rich class. Those who have made the Fortunate 400 even once are in an elite class.

Although the key to joining the Fortunate 400 may be capital gains, this is not true with respect to the remainder of the top 1%. The percentage of income realized as capital gains increases as the percentile of the income cohort increases, but recent observations indicate that wage and entrepreneurial income is the dominant form of income for all income cohorts. Only for the top 0.5% do capital gains approach or exceed 20% of the income.

Income Composition by Size of Total Income, 1998 <sup>42</sup>				
Group	Wages	Entrepreneurship	Capital Income	Capital Gains
90-95%	89.6	5.3	5.1	1.9
95-99%	79.8	12.3	7.9	6.3
99-99.5%	69.0	22.0	11.0	12.3
99.5-99.9%	62.7	23.9	13.3	15.5
99.9-99.99%	57.8	26.1	16.1	22.1
99.99-100%	44.8	33.3	22.0	20.9

The percentage of the income of the top 5% realized in the form of wages (including stock options), in contrast to capital gains and periodic income from capital, has increased steadily over the last half of the twentieth century, and the percentage of income realized as wages has grown dramatically for the smaller cohorts at the very top.

This change in income composition of the top 1% is not attributable, however, to changes in the pattern of realization of capital gains and periodic income from capital; both remain highly concentrated in the highest-income cohorts.<sup>43</sup> Rather, the change in income composition is attributable to dramatic increases in the wage level of top earners relative to everyone else—the phenomenon of the winner-take-all market economy of the United States at the turn of the millennium.<sup>44</sup> More than half of the “very top” taxpayers derived the major part of their income in the form of wages and salaries.<sup>45</sup> The “working rich” dominate the smallest measured percentile cohorts, if

<sup>42</sup> Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 Q.J. ECON. 1, 15 tbl.III (2003). Table III has data for selected years from 1916 through 1998. For most selected years, the percentage of income of the top 0.01% realized as capital gains exceeded the percentage of income of the 99.9th to 99.99th percentile realized as capital gains. 1998 was aberrational.

<sup>43</sup> See *infra* notes 282-290 and accompanying text.

<sup>44</sup> See generally ROBERT H. FRANK & PHILLIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* (1995).

<sup>45</sup> Piketty & Saez, *supra* note 42, at 17.

not the Fortunate 400. Part of this might be attributed to athletes and other entertainers, many of whom earn astronomical salaries,<sup>46</sup> although there also is evidence to the contrary.<sup>47</sup> But most top 1% income earners—admittedly in this context a group that include the “wannabes” as well as the truly “income-rich” are engaged in business or professions.<sup>48</sup> The dramatic increases in the compensation of the chief executive officers (and certain other officers) of publicly held corporations also play a part. CEO pay has risen astronomically in the past forty years. Whereas the average CEO made forty-one times as much as the average worker in 1960, by 2001 the average CEO made 411 times as much as the average worker, and that was a decrease—possibly temporary due to a decline in the stock market—from the levels in the immediately preceding years, in which average CEO pay was as much as 531 times the level of the average worker.

CEO Pay as a Multiple of Average Worker Pay, 1960–2001<sup>49</sup>

1960	1970	1980	1990	1995	1996	1997	1998	1999	2000	2001
41	79	42	85	141	209	326	419	475	531	411

What kind of pay are we talking about here in dollars? According to *BusinessWeek*'s “52nd Annual Executive Pay Scoreboard,” the average CEO's pay in 2001 was \$11 million—many times the multiple necessary for entry into the top 0.10%—and that was a 16% decrease from the 2000 average.<sup>50</sup> As do all averages, however, the 2001 average presents a somewhat distorted picture. Lawrence J. Ellison, the CEO of Oracle, earned so much due to pocketing \$706 million from exercising stock options, that the rest of the CEOs averaged only \$9.1 mil-

<sup>46</sup> Martin J. McMahon, Jr. & Alice G. Abreu, *Winner Take All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 26 & n.86 (1998).

<sup>47</sup> Given the prominence of Black athletes and entertainers, one might intuit that if the earnings of entertainers and athletes contributed significantly to their inclusion in the top 1% of income earners that fact would be reflected in the racial demographics of the top 1%. Data indicate that this is not true. In 1983, non-Hispanic Blacks constituted 1.2% of the top 1% of income earners, but by 1992 non-Hispanic Blacks constituted only 0.1% of the top 1% of income earners. Edward N. Wolff, *Who Are the Rich? A Demographic Profile of High-Income and High-Wealth Americans*, in DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH, *supra* note 37, at 74, 96 tbl.3.9.

<sup>48</sup> See *id.* at 97 tbl.3.9, 101.

<sup>49</sup> HARTMAN, *supra* note 30; see KEVIN PHILLIPS, WEALTH AND DEMOCRACY: A POLITICAL HISTORY OF THE AMERICAN RICH 147, 153–56 (2002) (describing increasing CEO pay relative to average workers' wages).

<sup>50</sup> Louis Lavelle et al., *Executive Pay*, BUSINESSWEEK ONLINE (Apr. 15, 2002), at [http://www.businessweek.com/magazine/content/02\\_15/b3778012.htm](http://www.businessweek.com/magazine/content/02_15/b3778012.htm).



lion, a low not seen since 1997.<sup>51</sup> Many, of course, made far less than even that average. To break into the top 40 required annual compensation of over \$40 million.<sup>52</sup> But one does not even have to be a CEO to garner such munificent compensation. At least ten executives below the CEO level made between \$58 and \$128 million in 2001,<sup>53</sup> and annual pay of more than \$1 million is common for the second banana in publicly held corporations.<sup>54</sup>

### 3. The Super-Rich Are Taking a Substantially Bigger Slice of the Pie

So far, we have been examining relative average incomes of various percentile cohorts of the population. Another perspective on the distribution of incomes is to examine the percentage of total personal income realized by the various income cohorts. Over the final two decades of the twentieth century, the top 5% increased its share of national before-tax personal income at the expense of virtually every other group, including much of the top quintile. This small subset of the top quintile increased its share of incomes dramatically, and even most of that increase accrued to the top of the top of the pyramid. The data as presented by the CBO illustrate that the higher income cohorts gained at everyone else's expense.

Income Quintile	1979	1993	1997	2000	Percentage Change 1979-2000 <sup>56</sup>	Percentage Change 1997-2000 <sup>57</sup>
First	5.8	4.5	4.3	4.0	-31.03	-6.98
Second	11.12	9.8	9.1	8.6	-22.66	-5.49
Third	15.8	15.0	14.2	13.5	-14.56	-4.93
Fourth	22.2	21.6	20.4	19.6	-11.71	-3.92
Highest	45.5	49.8	52.6	54.8	+20.44	+4.18
Top 10%	30.5	34.6	37.8	40.6	+33.11	+7.41
Top 5%	20.7	24.4	27.8	30.7	+48.31	+10.43
Top 1%	9.3	11.9	14.9	17.8	+91.4	+19.46

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *The Top-Paid Chief Executives . . . and 10 Who Aren't CEOs*, BUSINESS WEEK ONLINE, (Apr. 15, 2002), at [http://www.businessweek.com/magazine/content/02\\_15/art02\\_15/al15top.gif](http://www.businessweek.com/magazine/content/02_15/art02_15/al15top.gif); see *Executive Compensation Scoreboard*, BUSINESS WEEK ONLINE (Apr. 15, 2002), available at <http://www.businessweek.com/pdfs/2002/0215-execpay.pdf>.

<sup>55</sup> CONG. BUDGET OFFICE, *supra* note 23, at 26-27, 32-33, app. B, tbls.B1-B & B1-C.

<sup>56</sup> *Id.* (calculations made by author based on these figures).

<sup>57</sup> *Id.* (calculations made by author based on these figures).

The picture of income distribution in the last years of the twentieth century is stunning. In both 1997 and 2000 the top 20% of the households had more income than everyone else combined, as well as in all of the intervening years.<sup>58</sup> The top 5% had more income than the bottom 60%. And the top 1% had nearly one-half as much as the bottom 40%. Expressed slightly differently, in 2000, the 1.1 million richest households measured by income had nearly one and one-half times more money than the 44.2 million poorest households measured by income.<sup>59</sup>

Again, the CBO presentation of the top quintile masks the difference between the top 1% and everyone else in the top quintile. Breaking down the top quintile into cohorts that exclude higher level cohorts reveals that the bottom half of the top quintile joined the bottom 80% in transferring a slice of the pie to those who were better off, and that within the top 10%, only the top 5% made any significant gains from 1997 through 2000, with most of those gains going to the top 1%.<sup>60</sup>

Percentile Shares of Before-Tax Income Within Top Quintile <sup>61</sup>						
<i>Income Cohort</i>	<i>1979</i>	<i>1993</i>	<i>1997</i>	<i>2000</i>	<i>Percent Change 1979-2000</i>	<i>Percent Change 1997-2000</i>
81st-90th%	15.0	15.2	14.8	14.2	-5.33	-4.05
91st-95th%	9.8	10.2	10.0	9.9	+1.02	-1.0
96th-99th%	11.4	12.5	12.9	12.9	+13.16	+/-0
Top 1%	9.3	11.9	14.9	17.8	+91.4	+19.46

Significantly, in the late 1990s, the pattern of increasing income shares differed from earlier years. Unlike earlier periods, from 1997 to 2000 it was not the top 20%, or 10%, or even the top 5% that was gaining income share at everyone else's expense. From 1997 to 2000,

<sup>58</sup> *Id.* at 33, app. B, tbl.B1-C.

<sup>59</sup> The top 1% consisted of 1.1 million households, while the bottom 40% included 44.2 million households. *Id.* at 26-27, 32-33, app. B, tbs.B1-B & B1-C.

<sup>60</sup> Data from the Staff of the Joint Committee on Taxation reveal that this distribution was not much changed in 2001. According to that data, the top 1% of taxpayers claimed 17.2% of all income, the top 5% claimed 31.3% of all income, and the top 10% claimed 42% of all income. See generally STAFF OF JOINT COMM. ON TAX'N, 107TH CONG., DISTRIBUTION OF CERTAIN FEDERAL TAX LIABILITIES BY INCOME CLASS FOR CALENDAR YEAR 2001 (JCX-2-01) (Comm. Print 2001), available at <http://www.house.gov/jct/x-2-01.pdf>.

<sup>61</sup> Calculations made by author based on information derived from CONG. BUDGET OFFICE, *supra* note 23, at 31, app. B, tbl.B1-C.

the only income cohort that increased its share of total income was the top 1%.

Although the CBO data do not address the share of economic income realized by smaller cohorts within the top 1%, some such data are available, and they parallel the data regarding increased dollar incomes. As any income cohort is broken down into increasingly smaller cohorts, the share of incomes realized by each successive higher level income cohort increases at an increasing rate. A somewhat more precise view of the pattern within the top 1% is revealed by calculations by Thomas B. Petska, Michael I. Strudler, and Ryan Petska from IRS Statistics of Income data based on AGI—a very different base than that used by the CBO. Although the percentages differ somewhat, the pattern is consistent. Their data show that almost one-half of the share of income realized by the top 1% is realized by the top 0.10%.<sup>62</sup> Thus, the top 0.10%—roughly 110,000 households out of nearly 110 million households in the United States at that time—had roughly the same income as the 1.9 million households immediately below them near the top of the pyramid. Their analysis of the data also shows that this elite 110,000 households realized a greater share of income than the 44.2 million households in the bottom 40%.<sup>63</sup>

### B. *Income Mobility and the Fallacy of the Horatio Alger Myth*

Americans believe in the Horatio Alger myth. They love, and believe in, rags-to-riches stories.<sup>64</sup> Opponents of progressive taxation use such anecdotal stories of income mobility to fight progressive taxation

<sup>62</sup> Petska et al., *supra* note 9, at 353 tbl.2.

<sup>63</sup> *Id.*

Percentile Shares of Before-Tax Income			
<i>Income Class</i>	<i>1979</i>	<i>1993</i>	<i>2000</i>
Bottom 20%	2.89	2.31	2.02
Second Quintile	8.37	6.99	6.03
Third Quintile	14.82	12.75	10.87
Fourth Quintile	23.91	21.52	18.69
81st–90th %	16.94	16.5	14.85
91st–95th %	10.89	11.22	10.72
95th–99th %	12.6	14.31	15.25
99th–99.9th %	6.3	8.73	11.09
Top 0.01%	3.28	5.66	10.49

<sup>64</sup> See generally THOMAS D. STANLEY & WILLIAM D. DANKO, *THE MILLIONAIRE NEXT DOOR* (1996).

on the grounds that income inequality merely reflects life cycle differentials. But the data tell a different story.

Examination of available data leads to the inescapable conclusion that the Horatio Alger myth is exactly that, a myth. Although some Americans experience "significant" income fluctuations from year to year,<sup>65</sup> the data do not support the conclusion that many households frequently move between broadly defined income classes.<sup>66</sup> An Urban Institute study found that in both the 1970s and 1980s, about half of the people in either the lowest or highest quintile at the beginning of the period were in the same quintile ten years later.<sup>67</sup> Another study found that about half of the young adults (ages twenty-two to thirty-nine) who were in the bottom quintile of the income distribution in 1968 still were in that quintile twenty-three years later, in 1991.<sup>68</sup> More significantly, three-quarters of those who were in the bottom quintile in 1968 were in the bottom 40% in 1991.<sup>69</sup> According to another study, only 13.8% of those who are in the bottom 30% for any given year have lifetime income in the top 30%, and only 2.6% of those who are in the top 30% for any particular year have lifetime income in the bottom 30%.<sup>70</sup> Both top to bottom mobility and rags-to-riches mobility are thus quite rare.

Focusing on the top of the income pyramid, 90% of those in the top decile for their age cohort at age forty-nine were in the top two deciles at age seventy-nine, and only 2% of individuals in the top decile for their age cohort at age forty-nine had fallen below the top three deciles by age seventy-nine.<sup>71</sup> At the top, then, almost all of the

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<sup>65</sup> See generally WILFRED T. MASUMURA, U.S. CENSUS BUREAU, PUB. NO. P70-56, CURRENT POPULATION REPORTS: DYNAMICS OF ECONOMIC WELL-BEING: INCOME, 1992 TO 1993, MOVING UP AND DOWN THE INCOME LADDER (1996), available at <http://www.census.gov/prod/2/pop/p70/p70-56.pdf> (last modified Feb. 26, 1997).

<sup>66</sup> See Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 559-61 (1998). In the early 1990s, 75% of the people whose incomes placed them among the poorest fifth of the population in one year remained in the poorest fifth of the population the following year. Peter Gottschalk & Sheldon Danziger, *Family Income Mobility—How Much Is There, and Has It Changed?*, in THE INEQUALITY PARADOX: GROWTH OF INCOME DISPARITY 92, 99 (James A. Auerbach & Richard S. Belous eds., 1998).

<sup>67</sup> Isabel V. Sawhill & Mark Condon, *Is U.S. Income Inequality Really Growing? Sorting out the Fairness Question*, POLICY BITES (Urban Inst., Wash., D.C.), June 1992, at 1-4.

<sup>68</sup> Gottschalk & Danziger, *supra* note 66, at 101.

<sup>69</sup> *Id.*

<sup>70</sup> DON FULLERTON & DIANE LIM ROGERS, WHO BEARS THE LIFETIME TAX BURDEN? 111 (1993).

<sup>71</sup> *Id.* at 109.

mobility is up, not down.<sup>72</sup> This finding is confirmed by other studies which show income mobility within one or two deciles, but not much income mobility across more dispersed deciles, within any particular age cohort.<sup>73</sup> Furthermore, because the percentage of people changing income category from one year to the next declined somewhat between the late 1960s and the early 1990s, income mobility diminished. Thus, the sharp increases in income disparities reflect true growth in disparities and not merely a reshuffling of the income distribution.<sup>74</sup>

All of this implies that increasing "income inequality within a single year is mirrored by a similar increase in inequality over Americans' lifetimes."<sup>75</sup> The data on income mobility support, rather than impugn, the case for graduated progressive taxation, both on the grounds of fairness and to effect redistribution.

## II. THE DISTRIBUTION OF AFTER-TAX INCOME AND WEALTH

### A. *After-Tax Dollar Incomes*

When all is said and done, what is most important is the distribution of after-tax income.<sup>76</sup> By this measure, despite its progressivity, the federal tax system really has done little to ameliorate the increasing disparities in income over the last two decades of the twentieth century. The CBO data show increasing after-tax income disparities.

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<sup>72</sup> The Department of the Treasury studied a sample of people filing tax returns every year from 1979 through 1988 and found that only 14% of taxpayers in the lowest quintile in 1979 were still in that quintile in 1988, while 65% of taxpayers in the highest quintile were in it both years. OFFICE OF TAX ANALYSIS, U.S. DEP'T OF THE TREASURY, HOUSEHOLD INCOME MOBILITY DURING THE 1980S: A STATISTICAL ASSESSMENT BASED ON TAX RETURN DATA 5-7 (1992) (illustrating that limiting the analysis to people filing tax returns in all ten years excluded people with the lowest incomes because they are not required to file tax returns). See generally W. MICHAEL COX & RICHARD ALM, FED. RES. BANK OF DALLAS, BY OUR OWN BOOTSTRAPS: ECONOMIC OPPORTUNITY AND THE DYNAMICS OF INCOME DISTRIBUTION (1995).

<sup>73</sup> See Bankman & Fried, *supra* note 66, at 559-60.

<sup>74</sup> Gottschalk & Danziger, *supra* note 66, at 108.

<sup>75</sup> MARTIN NEIL BAILY ET AL., GROWTH WITH EQUITY 72 (1993).

<sup>76</sup> See *infra* notes 522-562 and accompanying text.

Average After-Tax Income (2000 Dollars) <sup>77</sup>			
Group	1979	2000	Percent Change 1979–2000 <sup>78</sup>
1st Quintile	\$12,600	\$13,700	8.73
2d Quintile	\$25,600	\$29,000	13.28
3d Quintile	\$36,400	\$41,900	15.11
4th Quintile	\$47,700	\$59,200	24.11
5th Quintile	\$84,000	\$141,400	68.33
Top 10%	\$106,300	\$201,400	89.46
Top 5%	\$140,100	\$299,400	113.7
Top 1%	\$286,300	\$862,700	201.33

Mirroring the changes in before-tax income,<sup>79</sup> calculations based on the CBO data show each successive income class climbing up the income distribution pyramid realized a greater percentage increase in after-tax income than the income group below it. The second and third quintiles pulled significantly ahead of the lowest quintile, while the fourth quintile pulled ahead of the middle quintile by more than the middle quintile pulled ahead of the lowest quintile. And the top quintile appears to be in a class by itself. The percentage increase in its after-tax income outpaced the fourth quintile by four times as much as the increase for the fourth quintile exceeded that of the middle quintile.

<sup>77</sup> See CONG. BUDGET OFFICE, *supra* note 23, at 32–33 tbl.B-1C. More complete, but still selective, data are shown in the following table.

After-Tax Income, Selected Years, 1979–2000								
Income Class	1979	1982	1985	1988	1992	1995	1998	2000
Lowest Quintile	12,600	11,500	11,400	11,600	12,100	13,200	14,000	13,700
Second Quintile	25,600	23,900	24,200	24,500	25,200	26,900	28,700	29,000
Middle Quintile	36,400	34,400	35,800	37,100	37,200	38,800	41,200	41,900
Fourth Quintile	47,700	46,400	48,700	51,000	51,200	53,200	57,300	59,200
Fifth Quintile	84,000	84,300	96,500	108,000	105,100	109,000	129,100	141,400
All	40,700	40,000	43,100	46,100	46,200	48,100	54,100	57,000
Top 10%	106,300	109,000	129,000	147,100	141,500	145,600	181,100	201,400
Top 5%	140,100	145,800	177,200	208,000	197,300	203,200	265,400	299,400
Top 1%	286,300	321,800	421,500	537,900	484,900	487,100	721,100	862,700

<sup>78</sup> Calculations made by author.

<sup>79</sup> See *supra* notes 23–75 and accompanying text.

As with before-tax incomes, the CBO's presentation, which does not adequately break out the smaller income cohorts within the top quintile, masks the extent to which increases in averages for the top quintile, top 10%, and top 5% actually are attributable largely to enormous increases in income of the top 1%.

Average After-Tax Income Within the Top Quintile, 1979 and 2000			
<i>Group</i>	<i>1979</i>	<i>2000</i>	<i>Percent Change 1979-2000<sup>80</sup></i>
81st-90th %	\$61,700	\$81,400	31.93
91st-95th %	\$72,500	\$103,400	42.62
96th-99th %	\$103,550	\$158,575	53.14
Top 1%	\$286,300	\$862,700	201.33

The rate of after-tax income growth of all of the top quintile, except the top 1%, more nearly resembled the rate of income growth of the third and fourth quintiles than it did the top 1%. The after-tax income of the top 1% increased by nearly 150 percentage points more than the percentage by which the after-tax income of the 96th through 99th percentile increased, whereas the after-tax income of the 96th through 99th percentile increased by only 38 percentage points more than the percentage by which the after-tax income of the middle quintile increased.

The differences between the increases in before-tax income and the increases in after-tax income from 1979 to 2000 illustrate the special status of the super-rich. On the one hand, because tax rates generally fell during the period from 1979 to 2000, the first four quintiles saw their after-tax income increase at a higher percentage than the percentage at which their before-tax income increased.<sup>81</sup> On the other hand, the fifth quintile saw its after-tax income increase by a slightly lower percentage than the percentage at which its before-tax income increased. But this did not necessarily reflect increased progressivity. The tax cuts in the various tax acts in that time period were not distributed evenly across or within quintiles. Many of the tax cuts were effected through increases in the earned income tax credit, af-

<sup>80</sup> Calculations made by author.

<sup>81</sup> There is no inconsistency between reduced statutory tax rates for all income classes and an increase in overall effective tax rates, as indeed did occur between 1979 and 2000. The phenomenon is explained by the increased percentage of income realized by taxpayers subject to the higher marginal tax rates. As a larger percentage of income is realized by high-income taxpayers, more income is taxed at higher rates, even if those higher rates are somewhat lower than in earlier years.

fecting the first and, to a lesser extent because of its phase-out rules, the second quintile.<sup>82</sup> Other tax reductions were effected through items such as the child and education credits, which due to phase-out rules affected primarily the second through fourth quintiles, and the bottom of the fifth quintile.<sup>83</sup>

Changes in Before-Tax Income and After-Tax Income Compared, 1979–2000				
<i>Group</i>	<i>Before-Tax Dollar Change</i>	<i>After-Tax Dollar Change</i>	<i>Before-Tax Percent Change</i>	<i>After-Tax Percent Change</i>
1st Quintile	\$900	\$1100	6.57	8.73
2d Quintile	\$3500	\$3400	11.74	13.28
3d Quintile	\$5600	\$5500	12.53	15.11
4th Quintile	\$14,000	\$11,500	23.14	24.11
5th Quintile	\$80,700	\$57,400	69.69	68.33
81st–90th %	\$25,008	\$19,700	31.89	31.93
91st–95th %	\$41,800	\$30,900	43.32	42.62
96th–99th %	\$85,530	\$55,025	59.41	53.14
Top 1%	\$836,600	\$576,400	184.19	201.33

Breaking the top quintile down in to smaller income cohorts reveals that the 81st through 90th percentiles saw after-tax income increase at a higher percentage than the percentage at which its before-tax income increased. But the 91st through 99th percentile after-tax income increased by a lesser percentage than the percentage by which its before-tax income increased—a small difference for the 91st through the 95th percentile and a significant amount for the 96th through 99th percentiles. When we get to the top 1%, we discover the big winner. After-tax income grew by 17 percentage points more than before-tax income increased. No other income class saw after-tax income increase by more than 2.5 percentage points more than before-tax income increased.

### *B. Shares of Total After-Tax Income*

As illustrated in Part II.A, the top of the economic pyramid realizes an extraordinarily disproportionate share of before-tax income.<sup>84</sup> Policy makers have not responded to this ever-increasing growth in the disparity of incomes with any changes to the tax system that would reallocate

<sup>82</sup> See CONG. BUDGET OFFICE, AN ECONOMIC ANALYSIS OF THE TAXPAYER RELIEF ACT OF 1997, at 60–62 (2000), available at <http://www.cbo.gov/ftpdocs/19xx/doc1959/tp97.pdf> (last modified May 19, 2000).

<sup>83</sup> See *id.* at 24–27, 57–65 (detailing education credits and child credit).

<sup>84</sup> See *supra* notes 76–83 and accompanying text.



the tax burden to reflect these significant changes in the relative ability to pay taxes. Instead of increasing the progressivity of the tax system to meaningfully mitigate the rate at which the gulf between the rich and poor is widening, the policymakers have allowed the after-tax gulf to widen dramatically. The CBO data on the shares of after-tax incomes realized by each income class confirm this conclusion.

Shares of After-Tax Income <sup>85</sup>		
<i>Income Group</i>	<i>1979</i>	<i>2000</i>
Lowest Quintile	6.8	4.9
Second Quintile	12.3	9.7
Third Quintile	16.5	14.6
Fourth Quintile	22.3	20.2
81st-90th %	15.0	14.2
91st-95th %	9.8	9.6
96th-99th %	11.4	12
Top 1%	9.3	15.5

On an after-tax basis the top 5% has gained a share of income at everyone else's expense. Even the 91st through 95th percentile has lost income share to the top 5%.<sup>86</sup> And within the top 5%, the top 1% has grabbed the biggest share of the bigger slice of the pie, leaving the 96th through the 99th percentile only an additional sliver—at least compared to the top 1%'s extraordinarily increased share of pie.

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<sup>85</sup> CONG. BUDGET OFFICE, *supra* note 23, at 32-33 tbl.B-3C. The breakdown of the fifth quintile is from the author's calculations. The CBO data for the fifth quintile are presented as follows:

<i>Economic Income Group</i>	<i>1979 Pre-Tax Income</i>	<i>1979 After-Tax Income</i>	<i>2000 Pre-Tax Income</i>	<i>2000 After-Tax Income</i>
Highest	45.5	42.4	54.8	51.3
Top 10%	30.5	27.6	40.6	37.1
Top 5%	20.7	18.1	30.7	27.5
Top 1%	9.3	7.5	17.8	15.5

<sup>86</sup> This loss of income share by the 91st through 95th percentiles was a function of having been left behind by the top 5% in the 1990s. During the 1980s, the 91st through 95th percentiles joined the rest of the top 10% in gaining income share at the expense of the bottom 90%.

### C. Shares of Total Wealth

Wealth is strongly correlated to income.<sup>87</sup> Precise measurement of the distribution of wealth is difficult, because the data are difficult to collect.<sup>88</sup> Nevertheless, the various sources reveal consistent patterns, although details of the data may differ. Wealth in the United States is even more highly concentrated than income.<sup>89</sup> Like incomes, wealth has been becoming increasingly more concentrated,<sup>90</sup> but not at the same rate as the rate of growth of the concentration of incomes.<sup>91</sup> Wealth, however, is more concentrated at the top of the pyramid than income. By some estimates, for over a decade, the top 1% has held nearly 40% of the total value of net wealth, while the top 5% has held nearly 60% of net wealth.<sup>92</sup>

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<sup>87</sup> See generally EDWARD N. WOLFF, RECENT TRENDS IN WEALTH OWNERSHIP, 1983–1998 (Levy Econ. Inst. of Bard Coll., Working Paper No. 300, 2000), available at <http://www.levy.org/pubs/wp/300.pdf>.

<sup>88</sup> See generally ARTHUR B. KENNICKELL, AN EXAMINATION OF CHANGES IN THE DISTRIBUTION OF WEALTH FROM 1989–1998: EVIDENCE FROM THE SURVEY OF CONSUMER FINANCES (Levy Econ. Inst. of Bard Coll., Working Paper No. 307, 2000), available at <http://www.levy.org/modules/pubsublib/files/wp307.pdf>.

<sup>89</sup> See Wolff, *supra* note 47, at 78 tbl.3.2; see also Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99, 114–19 (2003).

<sup>90</sup> See Ana M. Aizcorbe et al., Div. of Research, Fed. Reserve Bd., *Recent Changes in U.S. Family Finances: Results from the 1998 and 2001 Survey of Consumer Finances*, 89 FED. RES. BULL. 1, 8 (2003), available at <http://www.federalreserve.gov/pubs/bulletin/2003/0103lead.pdf>. One study, based on the data from the Federal Reserve Board's Triennial Survey of Consumer Finances, concluded that almost the entire increase in concentration of wealth from 1989 to 1998 was attributable to increased wealth of the *Forbes* 400, and that there was little change in the concentration of wealth among the remainder of the population. KENNICKELL, *supra* note 88, at 7–9. This study acknowledges that there are defects in the Survey of Consumer Finances and that other studies that have made compensating adjustments conclude that there has been increased concentration of wealth around the very top of the distribution below the *Forbes* 400. *Id.*

<sup>91</sup> Wolff, *supra* note 47, at 77 tbl.3.2.

<sup>92</sup> Calculations of distributions of wealth generally do not include the present value of the right to Social Security benefits or employer-sponsored, defined-benefit plans. The retirement income provided by these plans generally is based on workers' salaries and years of work. Economists generally conclude that the income streams "cannot be translated directly into a current value because valuation depends critically on assumptions about future events and conditions—work decisions, earnings, inflation rates, discount rates, mortality, and so on—and no widely agreed upon standards exist for making these assumptions." Aizcorbe, *supra* note 90, at 14; see William G. Gale, *The Effects of Pensions on Household Wealth: A Reevaluation of Theory and Evidence*, 106 J. POL. ECON. 706, 720 (1998) (stating that "pension wealth data are of generally poor quality; all methods of calculating pension wealth in defined benefit plans are likely to create measurement error"). Nevertheless, in analyzing retirement income security, economists do attempt to quantify Social Security and pension wealth. See Dorothy A. Brown et al., *Social Security Reform: Risks, Returns, and Race*, 9 CORNELL J.L. & PUB. POL'Y 633, 654–55 (2000). See generally ALAN L.

Distribution of Net Worth (By Population Segments) <sup>93</sup>					
Wealth Class	1983	1989	1992	1995	1998
Top 1%	33.8	37.4	37.2	38.5	38.1
Next 4%	22.3	21.6	22.8	21.8	21.3
Next 5%	12.1	11.6	11.8	11.5	11.5
Next 10%	13.1	13.0	12.0	12.1	12.5
Next 20%	12.6	12.3	11.5	11.4	11.9
Middle 20%	5.2	4.8	4.4	4.5	4.5
Bottom 40%	0.9	-0.7	0.4	0.2	0.2

GUSTMAN ET AL., PENSION AND SOCIAL SECURITY WEALTH IN THE HEALTH AND RETIREMENT STUDY (Nat'l Bur. of Econ. Research, Working Paper No. 5912, 1997). For one possible calculation of net worth including the annuity value of Social Security benefits and defined-benefit pensions, see generally ARTHUR B. KENNICKELL & ANNIE E. SUNDÉN, PENSIONS, SOCIAL SECURITY, AND DISTRIBUTIONS OF WEALTH (Bd. of Governors, Fed. Reserve Sys., Fin. & Econ. Discussion Series No. 1997-55, 1997), available at <http://www.federalreserve.gov/pubs/feds/1997/199755/199755pap.pdf>. According to this study, including defined-benefit pension and Social Security "wealth" reduces the share of wealth held by the top 0.5% from 24% of all net worth to 12%; and the net worth share of the bottom 90% rises from 31% to 54%. This is because the bottom 90% hold the overwhelming majority of pension and Social Security wealth, and Social Security and pensions constitute approximately 82% of total net worth. Nevertheless, one must not lose sight of the fact that under either wealth definition, about 45% of all business assets and about 30% of publicly traded corporate stocks are held by the top 0.5%. The non-pension assets of the bottom group are also determined mostly by their large share of principal residences and the associated debt. *Id.* at 11. The effects of pension wealth on other types of savings is not consistent. Defined-benefit plan coverage and IRAs have a negative correlation with non-pension net worth, but defined-contribution plans, such as § 401(k) plans and Social Security, both appear to have an insignificant result on non-pension savings. *Id.* at 17. When pension wealth is factored into the calculation of wealth shares, a significant distortion is introduced because pension wealth generally is calculated on a pre-tax basis, whereas other wealth is calculated on an after-tax basis. Gale, *supra* at 720. Finally, it is important to remember that unlike wealth in the form of cash, stock, bonds, real estate, and small businesses, Social Security and defined-benefit pension wealth are illiquid and do not provide current spending or economic power.

<sup>93</sup> WOLFF, *supra* note 87, at tbl.2. Net worth is defined as the current value of all marketable assets minus total liabilities. Total assets include only the following: (1) the gross value of owner-occupied housing, (2) other real estate, (3) cash and demand deposits, (4) time and savings deposits, certificates of deposit, and money market accounts, (5) government bonds, corporate bonds, foreign bonds, and other financial securities, (6) the cash surrender value of life insurance plans, (7) the cash surrender value of pension plans, including IRAs, Keogh, and § 401(k) plans, (8) corporate stock and mutual funds, (9) net equity in unincorporated businesses, and (10) equity in trust funds. Total liabilities are the sum of the following: (1) mortgage debt, (2) consumer debt, including auto loans, and (3) other debt. The value of nonmarketable pension plan benefits and Social Security benefits is not included. *Id.* at 2; see Barry W. Johnson & Lisa M. Schreiber, Internal Revenue Serv., *Personal Wealth, 1998*, 22 STATISTICS OF INCOME BULL. 87, 88 (Winter 2002-2003) (indicating that the top 3.4% of wealth holders, measured by gross assets, held 32.6% of U.S. assets and 35.2% of net worth), available at <http://www.irs.gov/pub/irssoi/98pwart.pdf>.

Other estimates show less concentration in the top 1%, offset by a larger share held by the 90th to 99th percentile, but the measure of the difference is not so significant as to change the import of the data.<sup>94</sup> In any event, the top 1% alone holds more wealth than the bottom 80% or 90%.<sup>95</sup>

Although consistent data for smaller cohorts within the top 1% are difficult to obtain, what data there are demonstrate that the same pattern that occurs with respect to income distributions occurs with respect to wealth. The top of the top is different from the bottom of the top. In 1989, the top 1%, by wealth, owned 33.5% of all assets. Of this, the 99th to 99.4th percentile held 7.4%, and the 99.5th to 100th percentile—the top 0.5%—held 26.1%.<sup>96</sup> Net worth was even slightly more concentrated.<sup>97</sup> More recent data from the Internal Revenue

<sup>94</sup> See generally KENNICKELL, *supra* note 88 (discussing data from Federal Reserve Board Triennial Survey of Consumer Finances).

Proportion of Net Worth, 1998

Cohort	Percent of Net Worth
99.5%–100%	25.8
99%–99.5%	8.2
90%–99%	34.7
0%–89.9%	32.7

The data from the Federal Reserve Board Triennial Survey of Consumer Finances explicitly omit data with respect to the Fortunate 400. *Id.* For 1998, that group was estimated to hold net wealth equal to held 2.6% of the total wealth. *Id.* If the Fortunate 400 were included in the top 0.5%, these data would more nearly resemble the data in the text.

<sup>95</sup> See ARTHUR B. KENNICKELL, SURVEY OF CONSUMER FIN., FED. RESERVE SYS., A ROLLING TIDE: CHANGES IN THE DISTRIBUTION OF WEALTH IN THE U.S., 1989–2001, at 9 (Levy Econ. Inst. of Bard Coll., Working Paper No. 393, 2003), available at <http://www.levy.org/modules/publib/files/wp393.pdf>.

Year	Percentile Group	Percentile Group	Percentile Group	Percentile Group	Percentile Group
	0–49.9	50–89.9	90–94.9	95–98.9	99–100
1989	2.7	29.9	13.0	24.1	30.3
1992	3.3	29.7	12.6	24.4	30.2
1995	3.6	28.6	11.9	21.3	34.6
1998	3.0	28.4	11.4	23.3	33.9
2001	2.8	27.4	12.1	25.0	32.7

<sup>96</sup> See HOUSE COMM. ON WAYS & MEANS, 103D CONG., OVERVIEW OF ENTITLEMENT PROGRAMS 1553 tbl.2 (Comm. Print 1993).

<sup>97</sup> From 1983 to 1989, the richest 1% of American families increased its share of the nation's total private wealth from 31.3% to 36.2%. The group's net worth was over \$6 trillion; it held over \$3 trillion of real estate, stocks, bonds, and other financial assets. ARTHUR B. KENNICKELL & R. LOUISE WOODBURN, ESTIMATION OF HOUSEHOLD NET WORTH USING MODEL-BASED AND DESIGN-BASED WEIGHTS: EVIDENCE FROM THE 1989 SURVEY OF CONSUMER FINANCES (1992), available at <http://www.federalreserve.gov/pubs/oss/oss2/papers/concentration.1989.final.pdf>; see EDWARD N. LUTTWAK, THE ENDANGERED AMERICAN DREAM: HOW

Service Statistics of Income Division (albeit using a different baseline measure of wealth) indicate that in 1998 the top 0.5% held over three-quarters of the wealth held by the top 1%.<sup>98</sup> This is consistent with data from the Federal Reserve Board's Triennial Survey of Consumer Finances for 1998.<sup>99</sup> The data consistently show the top 0.5% holding more than 25% of personal net wealth in the United States.

Furthermore, in examining the distribution of wealth, there is an analogue to the IRS's Fortunate 400 highest income earners. For wealth, the group is the *Forbes* 400—a list of the 400 wealthiest Americans published annually by *Forbes* magazine. From 1989 to 1999 the threshold for joining this elite group grew by 74%, to \$609 million, measured in constant 1998 dollars.<sup>100</sup> The average wealth of the top ten individuals grew by 611% to nearly \$27.1 billion. Some estimates conclude that from 1989 to 1999, the percentage of total wealth held by the *Forbes* 400 grew from 1.5% to 2.6%. (With the stock market decline in the early 2000s, the *Forbes* 400's share of total wealth is estimated to have fallen to 2.2% in 2001.<sup>101</sup>) Other estimates conclude that this group's share of total wealth grew from about 1% in the early 1980s to closer to 3% in 2002.<sup>102</sup> This growth in wealth was not even, and it was not evenly distributed. Between 1989 and 1995, most measures of the wealth of the wealthiest people grew fairly modestly in real terms, but from 1996 through 1999, there were dramatic increases. But the data indicate that the most significant increases in wealth were at the very top, and they tapered off at lower levels.<sup>103</sup>

It is true that much wealth in the United States today is newly created. On the one hand, *Forbes* magazine's list of the ten wealthiest persons in the country in 2003 includes self-made billionaires Bill Gates, Warren Buffett, Paul Allen, Lawrence Ellison, and Michael Dell. On the other hand, many fortunes are inherited; five of Sam Walton's heirs—individually, not collectively—also made the top

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TO STOP THE UNITED STATES FROM BECOMING A THIRD WORLD COUNTRY AND HOW TO WIN THE GEO-ECONOMIC STRUGGLE FOR INDUSTRIAL SUPREMACY 163–64, 175 n.35 (1993).

<sup>98</sup> Johnson & Schrieber, *supra* note 93, at 98–99 (stating that the top 1% held 23.5% of wealth, measured by gross assets, and the top 0.5% held 18.3%).

<sup>99</sup> KENNICKELL, *supra* note 88, at 10 tbl.6d.

<sup>100</sup> *Id.* at 3 tbl.1.

<sup>101</sup> KENNICKELL, *supra* note 95, at 3.

<sup>102</sup> WOJCIECH KOPCZUK & EMMANUEL SAEZ, TOP WEALTH SHARES IN THE UNITED STATES, 1916–2000: EVIDENCE FROM ESTATE TAX RETURNS 27 (Nat'l Bureau of Econ. Research, Working Paper No. 10399, 2003), available at <http://emlab.berkeley.edu/users/saez/estatelong.pdf>.

<sup>103</sup> See generally KENNICKELL, *supra* note 88.

ten.<sup>104</sup> The Walton heirs' status is just one illustration that much of the wealth in the United States is dynastic.<sup>105</sup> Many other members of the club that constitute the *Forbes* 400 acquired their wealth by inheritance. In 1999, half of the *Forbes* 400's fortunes originated with inherited wealth.<sup>106</sup> A number of studies indicate that approximately 50% of the wealth in the United States is inherited.<sup>107</sup> Thus, although there is churning of identities within this elite group, there is still a high degree of stability of high wealth status.<sup>108</sup>

Regardless of whether we are considering inherited wealth or self-created wealth, one thing is clear. Because high incomes and high wealth are highly correlated, if the progressivity of the tax system *at the high end* continues to erode, wealth will become even more concentrated in the future than it is now.

### III. EFFECTIVE TAX RATES

#### A. Individual Taxes

##### 1. The Individual Income Tax Rate Schedule

Progressivity has always been an essential element of the income tax in the United States, even though progressive income tax rates have always been controversial.<sup>109</sup> The 1913 income tax had a low, relatively flat-rate structure with generous exemptions. Although high marginal rates—going to over 90%—were enacted to fund World War

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<sup>104</sup> *The Richest People in America: The Forbes 400*, FORBES.COM, at <http://www.forbes.com/richlist2003/rich400land.html> (Sept. 18, 2003).

<sup>105</sup> See James R. Repetti, *Democracy, Taxes and Wealth*, 76 N.Y.U. L. REV. 825, 849 (2001).

<sup>106</sup> Dinesh D'Souza, *The Billionaire Next Door*, FORBES, Oct. 11, 1999, at 50.

<sup>107</sup> Repetti, *supra* note 105, at 849 n.142.

<sup>108</sup> KENNICKELL, *supra* note 95, at 48.

<sup>109</sup> See JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 67–154 (1985) (describing the historical development of the income tax); Geier, *supra* note 89, at 100–05. See generally ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995); Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987); Walter J. Blum & Harry Kalven Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952); Barbara Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157 (1999); Marjorie E. Kornhauser, *Equality, Liberty and a Fair Income Tax*, 23 FORDHAM URB. L.J. 607 (1996) [hereinafter Kornhauser, *Fair Income Tax*]; Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465 (1987) [hereinafter Kornhauser, *The Rhetoric*]; Marc Linder, *Eisenhower-Era Marxist-Confiscatory Taxation: Requiem for the Rhetoric of Rate Reduction for the Rich*, 70 TUL. L. REV. 905 (1996); McMahon & Abreu, *supra* note 46; Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?* 53 TAX L. REV. 51 (1999).

I, those high rates were rolled back in the 1920s. Steeply graduated progressive rates, rising to higher than 90% at the top of the scale, reappeared in the 1940s in response to the need for revenues during World War II. High marginal rates for taxpayers in the top decile continued to characterize the income tax rate schedules until 1981.<sup>110</sup> For the most part, however, until the inflation-driven bracket creep of the mid-1960s, the income tax system was largely flat-rate or mildly progressive for the masses, with steeply progressive surtaxes on a relatively small percentage of the population.<sup>111</sup>

Progressivity went into decline in 1981, partially rebounded in the 1990s, but has never recovered to its pre-1981 level. Between 1981 and 1985, the largest percentage cuts in individual income tax rates went to the highest income groups.<sup>112</sup> The decline of progressivity began with the 1981 Act, which eliminated all marginal brackets above 50%.<sup>113</sup> The eliminated brackets applied almost exclusively to current yield from capital, but the changes had the important ancillary effect of reducing the maximum rate on long-term capital gains from 28% to 20%. In general, income from capital got a big break. In addition, through adjustments in the remaining rate brackets, taxpayers in al-

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<sup>110</sup> In 1964 the top rate was reduced to 70% as part of a general tax cut, and in 1969 the top rate on "earned income" was reduced to 50%. Other income, however, was subject to tax up to 70%, except capital gains, the top rate on which varied from 25% to 35% through the 1960s and 1970s.

<sup>111</sup> In 1961, for example, the bottom quintile of tax filers faced a zero rate due to the personal exemptions and standard deduction. The first three rates—20%, 22%, and 24%—applied to the next 70% of taxpayers, and the steeply graduated rates, which at that time went to 90%, applied to 10% or less of filers at the top of the income distribution. See C. EUGENE STEUERLE, *THE TAX DECADE 23* (1991). The marginal rates above 38% applied to less than 1% of all return filers, about 1.1% of taxable returns. Calculations made by author based on information derived from INTERNAL REVENUE SERV., *STATISTICS OF INCOME 1962 INDIVIDUAL INCOME TAX RETURNS 110-13 & tbl.20* (1965). The top 0.5% of filers, by AGI class, were subject to marginal tax rates of 50% or more; slightly less than 0.4% of filers were in marginal tax rates brackets higher than 50%. Calculations made by author based on information derived from *id.*

<sup>112</sup> See generally Richard Kasten et al., *Trends in Federal Tax Progressivity 1980-93*, in *TAX PROGRESSIVITY AND INCOME INEQUALITY*, at 9 (Joel B. Slemrod ed., 1994).

<sup>113</sup> See WITTE, *supra* note 109, at 222. This slashing of the top rates was akin to the Andrew Mellon-led tax cuts of the 1920s. *Id.* at 234. In contrast, the reduction of the top rate on earned income from 70% to 50% in 1969 was coupled with other changes, restricting deductions and creating the alternative minimum tax, which resulted in no net tax relief for the income class benefiting from the nominal statutory rate reduction. *Id.* at 228-35. Notwithstanding the resemblance of the 1981 Act to the Mellon-led Republican tax cuts of the 1920s, however, the tax cuts in the 1981 Act, in toto, reflected the end result of a bidding war between the Republicans and the Democrats to see who could provide the biggest tax cut. The result was truly bipartisan. See Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1198-206 (1983).

most every rate bracket received approximately a 10% rate reduction. Every prong of the 1981 Act reduced progressivity. The effect of elimination of the brackets above 50% is obvious, but it was even more anti-progressive than it appears on the surface because it was, to a large extent, tax relief for dividends, the receipt of which is highly concentrated in the highest-income classes.<sup>114</sup> That the other two changes reduced progressivity is not quite so facially obvious, but it is equally certain. The benefits of reduction of capital gains rates inure disproportionately to high-income taxpayers because capital gains realizations are highly concentrated in high-income taxpayers.<sup>115</sup> Even the 10% across-the-board reduction in rates reduced progressivity. Across-the-board percentage cuts increase inequality in private before-tax income because they reduce taxes of higher-income taxpayers proportionately more than they reduce taxes of lower-income taxpayers.<sup>116</sup>

Five years later the rate structure was radically changed by the 1986 Act, which reduced the rate brackets to 15% and 28%.<sup>117</sup> Because of significant base broadening, the elimination of the preferential treatment of capital gains, and an increase in effective corporate tax rates, the 1986 Act resulted in decreased tax effective rates for all income classes below the top quintile.<sup>118</sup> The lowest income classes benefited significantly from the 1986 Act, primarily due to expansion of the earned income credit, but across most of the spectrum, the 1986 Act was to a large extent distributionally neutral. Some analysts

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<sup>114</sup> See GREGG A. ESENWEIN & JANE G. GRAVELLE, CONG. RESEARCH SERV., LIBRARY OF CONG., AN ANALYSIS OF THE TAX TREATMENTS OF CAPITAL LOSSES 7-8 (2002), available at [http://www.law.umaryland.edu/marshall/ElectronicResources/crsreports/crsdocuments/RL31562\\_10092002.pdf](http://www.law.umaryland.edu/marshall/ElectronicResources/crsreports/crsdocuments/RL31562_10092002.pdf); Leonard E. Burman & Deborah I. Kodes, *Composition of Income Reported on Tax Returns*, 101 TAX NOTES 783, 783 (2003); Leonard E. Burman & Peter D. Ricoy, *Capital Gains and the People Who Realize Them*, 50 NAT'L TAX J. 427, 432 (1997); Jane G. Gravelle, *Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences*, 56 NAT'L TAX J. 653, 654 (2003).

<sup>115</sup> See ESENWEIN & GRAVELLE, *supra* note 114, at 7-8; Burman & Kodes, *supra* note 114, at 783; Burman & Ricoy, *supra* note 114, at 432.

<sup>116</sup> JANE G. GRAVELLE, CONG. RESEARCH SERV., LIBRARY OF CONG., ACROSS-THE-BOARD TAX CUTS: ECONOMIC ISSUES 6-8 (2001), available at [http://www.law.umaryland.edu/marshall/ElectronicResources/crsreports/crsdocuments/RL30779\\_09242001.pdf](http://www.law.umaryland.edu/marshall/ElectronicResources/crsreports/crsdocuments/RL30779_09242001.pdf).

<sup>117</sup> There was, however, a disguised 33% rate bracket, on what might loosely be described as the upper middle class. See BORIS I. BITTKER & MARTIN J. MCMAHON, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 40.2 (1988); Andrew B. Lyon, *Individual Marginal Tax Rates Under the U.S. Tax and Transfer System*, in DISTRIBUTIONAL ANALYSIS OF TAX POLICY 214, 218-22 (David F. Bradford ed., 1995).

<sup>118</sup> See CONG. BUDGET OFFICE, *supra* note 23, at 22-23, app. B, tbl.B1-A (comparing listed effective rates for years before 1987, when most of the changes in the 1986 Act became fully effective, and 1987 through 1990, before the next subsequent act significantly affecting progressivity).



find the changes to have been mildly progressive,<sup>119</sup> although others find the changes to have mildly reduced progressivity.<sup>120</sup> Nevertheless, because the net effect of most of the changes in the 1986 Act was to lock in the effect of changes in the tax acts in 1981, 1982, and 1983, from the perspective of the top 1% vis-à-vis everyone else, effective tax rates after the 1986 Act were less progressive than they were immediately before the 1981 Act.<sup>121</sup>

As subsequently analyzed by the House Committee on Ways and Means, the changes in the individual income tax burdens in the 1980s lopsidedly favored those at the top of the very top of the economic pyramid.

Change in Average Effective Income Tax Rates: 1977-1990 <sup>122</sup>	
<i>Income Class</i>	<i>Percent Change</i>
Lowest Quintile	N/A (negative rates)
2d Quintile	-7.6
3d Quintile	-6.8
4th Quintile	-8.3
81%-90%	-7.3
91%-95%	-7.4
96%-99%	-5.9
Top 1%	-18.9

These data show the top 1% getting twice as much tax relief as the middle class, and an even higher multiplier of the tax relief than the nearly rich in the 96th through 99th percentiles.

The disproportionate tax cuts accorded to the very highest income class in the 1980s set the stage for the introduction in 1991 of the 31% bracket and in 1993 of the 36% and 39.6% brackets, the lat-

<sup>119</sup> See STEUERLE, *supra* note 111, at 122-25; Petska et al., *supra* note 9, at 345-47 & tbl.5.

<sup>120</sup> Kasten et al., *supra* note 112, at 10.

<sup>121</sup> See Petska et al., *supra* note 9, at 346 tbl.E. It was not possible to expand the base sufficiently to recoup the one-third cut in tax rates for high-income taxpayers, a large percentage of the income of which came from interest, dividends, and capital gains. Full taxation of capital gains alone would not have sufficed. Repeal of the deduction for state and local income taxes might have helped compensate for the reduced rates, but such repeal was impossible for political reasons. See STEUERLE, *supra* note 111, at 112-14. Elimination of tax shelters through the passive activity loss restrictions in I.R.C. § 469 resulted in some base broadening. *Id.*; see TIMOTHY J. CONLAN ET AL., TAXING CHOICES 26-30 (1990); SHELTON D. POLLACK, THE FAILURE OF U.S. TAX POLICY 98-106 (1996).

<sup>122</sup> HOUSE COMM. ON WAYS & MEANS, *supra* note 96, at 1516 app. K, tbl.26. The negative income tax rates for the lowest quintile result from the refundability of the § 32 earned income tax credit.

ter applying to taxable incomes over \$250,000 (indexed for inflation).<sup>123</sup> The higher rates enacted in 1993 were intended solely to apply to those who benefited the most from the tax cuts of the 1980s. The new higher brackets initially affected less than 4% of taxpayers—those at the very top of the income distribution.<sup>124</sup> Nevertheless, the increased progressivity fostered by those rate increases was somewhat ameliorated four years later when, in 1997, the rates on most long-term capital gains were significantly reduced, from 28% to 20%.<sup>125</sup>

## 2. Payroll Taxes

Important changes in the 1970s and 1980s that dramatically affected the distribution of overall federal tax burdens had nothing to do with the income tax. In addition to income taxes, the federal government levies payroll taxes on wages and self-employment income. Payroll taxes were first introduced in 1935 to fund the Social Security system, but they now also fund Medicare (starting in 1965) and federal unemployment compensation. Payroll taxes are imposed on wages and self-employment income, starting with the first dollar, with no exceptions or exclusions,<sup>126</sup> but they are dramatically reduced after wages or self-employment income exceeds an applicable ceiling for the year. Although the payroll tax rate is proportional with respect to its base, the burden of the tax is regressive. Regressivity results from the combined effects of the absence of a floor exempting some income and the imposition of a ceiling on wages subject to the largest portion of the tax.<sup>127</sup> Statutory payroll tax rates have risen from 8.8% in 1967 to 15.3% currently.

The payroll tax (excluding unemployment compensation) currently consists of two components. The first component is the 6.2%

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<sup>123</sup> As a result, the share of total federal taxes paid by the top 1% increased from 14.9% in 1990 to 15.8% in 1994, and the share of taxes paid by the remainder of the top 5% increased from 14.9% to 15.2%. The share of all other groups decreased. *See id.* at 1515 tbl.25.

<sup>124</sup> *See* Therese M. Cruciano & Michael Strudler, Internal Revenue Serv., *Individual Income Tax Rates and Tax Shares, 1993*, 16 STATISTICS OF INCOME BULL. 7, 10 & fig.C (Summer 1996).

<sup>125</sup> *See* Petska, *supra* note 9, at 345–47 tbl.E.

<sup>126</sup> Payroll taxes effectively can be refunded though the refundable earned income credit in I.R.C. § 32. *See* BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAR, *FEDERAL INCOME TAXATION OF INDIVIDUALS* § 27.02 (3d ed. 2002). The refundable earned income credit can result in negative income tax rates, but the combined income tax and payroll tax rate for low-income workers can remain positive.

<sup>127</sup> *See* Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 864–65 (1987).

Social Security tax on wages below a specific ceiling that increases each year as wages in the economy generally increase. For 2003 the Social Security component of the payroll tax is levied on the first \$87,000 of wages, without any exemptions, for a maximum of \$5394. The second component of payroll taxes is the 1.45% Medicare tax on all wages, again without any exemptions, but without a ceiling. The payroll tax is collected from both the employer and the employee, so the Social Security component actually is 12.4% (a maximum of \$10,788) and the Medicare component is 2.9%, for a total of 15.3%. Self-employed individuals pay these percentages on self-employment income, subject to the same ceiling on the Social Security component. From the employee's side, payroll taxes are neither deductible nor creditable in computing income taxes, but self-employed individuals may deduct one-half of self-employment taxes in computing income taxes.<sup>128</sup> Employers deduct their share of payroll taxes if the wages are paid in a profit-seeking activity.

Although income tax rates—particularly the rates imposed on the top of the income pyramid—have fallen dramatically over the last forty years, both the payroll tax rate and base have increased markedly during that period, dramatically increasing payroll tax receipts. Through 1949, the combined employer and employee Social Security tax was 2% (1% each), which was imposed on wages up to \$3000.<sup>129</sup> Over the years, as necessary to keep the system solvent, Congress increased both the rate and the ceiling. Starting in 1975, the ceiling was increased for inflation (except from 1979 through 1981 when ceilings were increased ad hoc by Congress).<sup>130</sup> Generally speaking, the goal was to collect, in any given year, payroll taxes somewhat more than enough to pay current benefits, but not to fully fund accrued benefits.<sup>131</sup> From 1974 through 1982, the combined (employer and employee) payroll tax rate (including Medicare, added in 1965) rose from 11.7% to 13.3%.<sup>132</sup> In 1983, spurred largely by the urging of Alan Greenspan to better fund

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<sup>128</sup> I.R.C. § 164(f) (West Supp. 2004). Generally speaking, the purpose of this deduction is to equalize the AGI of an employee and a self-employed individual, who otherwise have realized the same net earnings before taxes.

<sup>129</sup> Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 24 (2002).

<sup>130</sup> See JOSEPH PECHMAN, *FEDERAL TAX POLICY* 215 (5th ed. 1987).

<sup>131</sup> See Patricia E. Dille, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 1031 (2000).

<sup>132</sup> See HOUSE COMM. ON WAYS & MEANS, 101ST CONG., *BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS* 67 (Comm. Print 1989).

future accrued benefits,<sup>133</sup> Congress revised the Social Security system. The goal was to increase the excess of taxes collected over benefits paid out in order to further increase the balance in the Social Security trust fund.<sup>134</sup> Under the Social Security Amendments of 1983,<sup>135</sup> the combined Social Security payroll tax rate rose to 12.4% and the combined Medicare payroll tax rose to 2.9%.<sup>136</sup> The 1983 legislation also provided a formula to increase the rate at which the ceiling on Social Security taxes was raised. As a result, the payroll tax burden has increased substantially, with higher rates and a ceiling on the Social Security portion of the tax that increases annually for inflation. From the mid-1960s through 2003, payroll tax receipts increased from approximately 20% to about 40% of federal revenues.<sup>137</sup> Over the last twenty years, however, the growth of payroll taxes has been attributable to increases in the wage ceiling rather than rate increases. The rates have not been increased since 1990.

Payroll taxes in excess of those necessary to fund the Social Security system and Medicare on a pay-as-you-go basis are “invested” in the “social security trust fund,” which consists solely of a special issue of Treasury bonds.<sup>138</sup> The proceeds of the sale of those Treasury bonds to the Social Security trust fund are then used for general governmental expenditures, for example, military, farm subsidies, interest on the national debt, federal payroll, and so forth.<sup>139</sup> In other words, increased payroll taxes fund expenditures that generally are thought by most taxpayers to be funded by primarily the income tax. Over

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<sup>133</sup> See generally Soc. Sec. Admin., Report of the National Commission on Social Security Reform, Unempl. Ins. Rep. with Soc. Security (CCH) No. 1127 (spec. ed., Jan. 27, 1983), available at <http://www.ssa.gov/history/reports/gspan.html> (last visited Nov. 15, 2004). The Commission is informally known as the Greenspan Commission after its Chairperson, Alan Greenspan.

<sup>134</sup> The original design of the Social Security system not only did not contemplate that payroll taxes would be set at levels that exceeded current benefits, but contemplated that benefits would not be funded entirely out of payroll taxes. See Dilley, *supra* note 131, at 1006–07 (citing J. DOUGLAS BROWN, *ESSAYS ON SOCIAL SECURITY* 44–56 (1977)).

<sup>135</sup> Social Security Amendments of 1983, Pub. L. 98-21, 97 Stat. 65 (1983).

<sup>136</sup> See Federal Insurance Contributions Act (FICA), I.R.C. § 3101 (historical and statutory notes).

<sup>137</sup> OFFICE OF MGMT. & BUDGET, HISTORICAL TABLES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2005, at 31–32 tbl.2.2, available at <http://www.whitehouse.gov/omb/budget/fy2005/pdf/hist.pdf>.

<sup>138</sup> See, e.g., HOUSE COMM. ON WAYS & MEANS, *supra* note 132, at 66.

<sup>139</sup> See generally Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L.A. L. REV. 1063 (1997).

\$150 billion was added to the "trust fund" in 2002.<sup>140</sup> At the end of 2002, "the trust fund" held approximately \$1.4 trillion,<sup>141</sup> meaning that cumulatively nearly \$1.4 trillion dollars collected by the payroll tax ostensibly to fund Social Security and Medicare had been spent on general government operations. It is estimated that another \$1 trillion will be added to the trust funds—that is, spent on general government operations—by the year 2007.<sup>142</sup>

### B. *Effective Tax Rates*

One of the most frequently referenced norms for determining progressivity is what is known as "effective tax rates." An "effective tax rate" is determined by dividing tax liabilities (total or with reference to the allocable burden of a specific tax) by total income.<sup>143</sup> This method of analysis generally defines income in a normative manner, including in income many items that are exempt from taxation.<sup>144</sup> Tax liabilities taken into account generally include actual taxes paid. Therefore, the method does not employ tax expenditure analysis, under which normative taxes equal the normal statutory rate applied to a normative base, and the difference between the normative taxes so calculated and actual tax liability is treated as an offsetting government subsidy to the taxpayer.<sup>145</sup> Because of their differing methodologies, effective rate analysis using actual tax liabilities and tax expenditure analysis are mutually inconsistent and cannot be applied simultaneously.<sup>146</sup> Most, if

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<sup>140</sup> BD. OF TRS., FED. OLD-AGE & SURVIVORS INS. & DISABILITY INS. TRUST FUNDS, THE 2003 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS (2003), available at <http://www.ssa.gov/OACT/TR/TR04/tr04.pdf> (updated Mar. 17, 2003).

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at 26.

<sup>143</sup> CONG. BUDGET OFFICE, *supra* note 6, at xvii & fig.3.

<sup>144</sup> For a thorough explanation of the expanded income concept used by the CBO, see *id.* at 20–25. The concept includes both taxable cash receipts and tax-exempt transfer payments, withdrawals from retirement funds, as well as certain in-kind receipts and the employer's share of payroll taxes, but omits imputed income, unrealized appreciation, and gifts and inheritances.

<sup>145</sup> For tax expenditure analysis, see generally STANLEY S. SURREY & PAUL R. McDANIEL, *TAX EXPENDITURES* (1985).

<sup>146</sup> See generally Paul R. McDaniel, *Identification of the "Tax" in "Effective Tax Rates,"* 28 NAT'L TAX J. 273 (1985). Even though effective tax rate analysis employs an expanded income concept, because it focuses on actual tax liabilities rather than the normative tax liabilities found under tax expenditure analysis, the expanded income concept under effective tax rate analysis does not include in income the government subsidies to taxpayers determined under tax expenditure analysis. A more accurate picture might be presented if effective tax rates were determined by dividing the normative tax liabilities under tax expenditure analysis by ex-

not all, of the available data relating to tax burdens reflect actual tax liabilities rather than normative tax liabilities, and the data regarding the distribution of tax expenditure benefits are far less refined, even when they are available. Moreover, in the political arena, tax expenditures generally are viewed as “tax relief.” Thus, this Part focuses on effective rate analysis exclusive of tax expenditure analysis.

The CBO has published two major studies on effective tax rates in the past few years, one covering changes in the period 1979 through 1997,<sup>147</sup> and a second covering changes in the period 1997 through 2000.<sup>148</sup> The CBO studies provide data not only with respect to the overall effective federal tax rates, but with respect to the impact of income taxes, payroll taxes, and corporate taxes on each income quintile, as well as the top 10%, top 5%, and top 1%.

## 1. Income Tax

According to the CBO data, from 1979 to 1997, the effective income tax rate fell for the first four quintiles, but increased slightly for the top quintile.<sup>149</sup> The CBO also shows that the smaller cohorts within the top quintile, the top 10%, top 5%, and top 1%, saw slight increases in their effective federal income tax rates from 1979 to 1997, after dipping substantially after the 1986 Act and before the institution of the 36% and 39.6% marginal brackets in 1993.<sup>150</sup> From 1997 to 2000, the effective individual income tax rates for the lowest income quintile rose (but remained negative due to the refundability of the earned income credit). Effective income tax rates fell for those in the second and middle quintiles, remained constant for households in the fourth quintile, and rose for those in the highest quintile (including all smaller cohorts within the highest quintile).<sup>151</sup> These changes

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panded income that included not only direct government subsidies but also subsidies delivered through tax expenditures. No such comprehensive data are available.

<sup>147</sup> See generally CONG. BUDGET OFFICE, *supra* note 6.

<sup>148</sup> See generally CONG. BUDGET OFFICE, *supra* note 23. The statistics in the 2003 CBO study, which include the years covered in the 2001 study, differ from the comparable numbers in the 2001 study because of changes in the methodology used to create the data set for the analysis. The CBO advises readers who are comparing rates over time to use only data from the 2003 study and not to attempt to link that information to the data reported in the 2001 study. Among the most important differences are an increase in the share of total income going to the lowest quintile in virtually all years and an increase in the shares of total federal taxes being borne by households in the lower-income quintiles. *Id.* at 3.

<sup>149</sup> See *id.* at 11.

<sup>150</sup> *Id.* at 72; see Kasten et al., *supra* note 112, at 31 (reporting somewhat similar but not identical trends for a comparison of 1980, 1985, 1989, and 1993).

<sup>151</sup> Kasten et al., *supra* note 112, at 2, 23 tbl.B1-A.

in effective individual tax rates, however, were not due to statutory changes. According to the CBO, the increased individual income tax rates were attributable to bracket creep—inflation-adjusted income growth pushed more households into higher tax brackets—and disproportionately high income growth realized at the very top of the income distribution, which combined to make a larger share of income subject to the highest tax rate.<sup>152</sup>

How can the CBO data show an increase in effective income tax rates when rates have been cut? Part of the answer lies in changes in the base, because effective rate analysis uses an expanded definition of income, not AGI or taxable income.<sup>153</sup> But more importantly, even the CBO studies themselves caution that its methodology and data can “mask or even misrepresent information about subgroups or specific taxes.” The CBO points out that total effective tax rates can rise between any two years, even if effective rates for households in every income quintile fall.<sup>154</sup> Likewise, effective tax rates for a quintile can rise even though statutory tax rates for a subgroup remain constant or fall. As *shares* of income shift upward—that is, the real income of a higher income cohort increases disproportionately to a lower income cohort, a higher percentage of income is taxed at higher rates.<sup>155</sup> Finally, because of tax preferences, such as exclusions from taxable income for pension plan contributions, which are counted in total income in the CBO data, and the preferential rate for capital gains, shifting composition of income within an income class can affect the effective tax rate even if statutory rates remain unchanged. This last factor is very important. The data show that in the 1990s a smaller percentage of the income of top income earners was in the form of capital gains than it was in the 1980s and a larger percentage of the income of those earners was wage and other income taxed without any preference.<sup>156</sup> In 1998 more than half of the “very top

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<sup>152</sup> *Id.* at 2.

<sup>153</sup> See CONG. BUDGET OFFICE, *supra* note 6, at 20–24.

<sup>154</sup> See *id.* at xxiii. If income grows more rapidly for higher-income households facing higher tax rates, the total effective rate rises, even if tax rates do not change for income subgroups.

<sup>155</sup> The share of income received by the highest quintile climbed from 45.5% in 1979 to 54.8% in 2000, while the share for the lowest quintile fell from 5.8% to 4%. Households in the top 10% increased their share of income from 30.5% to 40.6%; households in the top 5% increased their share of income from 20.7% to 30.7%; and the top 1% saw their share of total income increase from 9.3% to nearly 17.8%. See CONG. BUDGET OFFICE, *supra* note 23, at 32–33 tbl.B-1C.

<sup>156</sup> See Piketty & Saez, *supra* note 42, at 15 tbl.III.

taxpayers derive[d] the major part of their income in the form of wages and salaries. . . . [T]he 'working rich' celebrated by Forbes magazine have overtaken the coupon-clipping rentiers."<sup>157</sup>

A study by Thomas B. Petska, Michael I. Strudler, and Ryan Petska has reached a different conclusion than the CBO regarding effective income tax rates.<sup>158</sup> Petska, Strudler, and Petska employed a "retrospective income concept," which uses the income and deduction items available in the 1979 to 1986 period as the base, and found that all income classes, except the lowest class and the top 10%, realized a substantial decrease in average tax rates from 1979 to 2000. In contrast to the CBO, however, they concluded that average tax rates for the top 1% of the income distribution decreased substantially from 1979 to 2000, with the top 0.10% of taxpayers having a 15.7% decrease, from 31.41% to 26.48%, and the remainder of the top 1% seeing a 14.07% decrease, from 27.43% to 23.57%.<sup>159</sup> In contrast, the remainder of the top 10% of taxpayers saw less than a 5% decrease in average tax rates.

## 2. Other Federal Taxes

Individuals' overall tax burdens reflect not only the income tax, but also payroll taxes, corporate income taxes, excise taxes, and wealth transfer (estate, gift, and generation-skipping) taxes. Individual income tax receipts constitute slightly less than 50% of total federal tax receipts.<sup>160</sup> In the late 1970s, corporate income taxes represented about 15% of federal tax receipts, but in recent years corporate income taxes have dropped to less than 10% of total federal taxes. In addition, various excise taxes collect slightly less than 4% of total taxes.

Payroll taxes are particularly important. In recent years, payroll taxes have risen to an amount equal to nearly 40% of federal tax receipts. Payroll taxes nominally are imposed to finance Social Security and Medicare specifically.<sup>161</sup> If earmarking of these receipts for these specific transfer programs is accepted at face value, it might be difficult

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<sup>157</sup> *Id.* at 17.

<sup>158</sup> Petska et al., *supra* note 9, at 346–47 tbl.5.

<sup>159</sup> Calculations made by author based on average tax rates for various years shown in *id.*

<sup>160</sup> OFFICE OF MGMT. & BUDGET, *supra* note 137, at 31–32 tbl.2.2.

<sup>161</sup> In addition to the payroll taxes to finance Social Security and Medicare, the federal government imposes Social Security taxes to finance unemployment compensation. The CBO data also take these taxes into account. See CONG. BUDGET OFFICE, *supra* note 23, at 60. These taxes are particularly regressive. See generally PATRICIA M. ANDERSON & BRUCE D. MEYER, UNEMPLOYMENT INSURANCE TAX BURDENS AND BENEFITS: FUNDING FAMILY LEAVE AND REFORMING THE PAYROLL TAX (Nat'l Bureau of Econ. Research, Working Paper No. 10043, 2003).



to evaluate these taxes without considering the distribution of the benefits they provide. Nevertheless, because federal expenditures apart from the transfer programs for which payroll taxes nominally are earmarked far exceed taxes other than payroll taxes (primarily, individual and corporate income taxes), and payroll taxes far exceed current Social Security and Medicare expenditures,<sup>162</sup> payroll taxes are to a large extent financing current general purpose government expenditures.<sup>163</sup> Thus, in analyzing tax burdens, payroll taxes should not be considered to be any different than the individual or corporate income taxes.

All of these other taxes, which ultimately are borne by individuals, should be taken into account along with the income tax in determining the progressivity of the federal tax system. The CBO studies have done so by determining the effective rate for each of these taxes for the various income classes.<sup>164</sup> In computing the effective rates, the CBO assumed, as do most economists,<sup>165</sup> that the employer's share of payroll taxes is borne by the employees. Thus, the amount of those taxes was included in employees' income, and the taxes were treated as part of employees' tax burden. The CBO treated corporate taxes as borne by owners of capital and allocated corporate taxes to households in proportion to their income from interest, dividends, rents, and capital gains.<sup>166</sup> Finally, the CBO assumed that excise taxes are borne by

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<sup>162</sup> See OFFICE OF MGMT. & BUDGET, *supra* note 137, at 22 tbl.1.1.

<sup>163</sup> The "Social Security trust fund" in reality is little more than an accounting mechanism to keep track of the amount of Social Security and Medicare payments that eventually will have to be funded out of taxes other than payroll taxes if payroll taxes are not increased.

<sup>164</sup> The CBO data do not take into account transfer taxes, that is, estate, gift, and generation-skipping taxes, because limitations in the data used in the studies make it difficult to allocate taxes among households and in part because of uncertainty about whether decedents or heirs bear the burden of those taxes. See CONG. BUDGET OFFICE, *supra* note 6, at xvii-xviii. Since 1987, these taxes continuously have constituted less than 0.5% of federal tax receipts. See Internal Revenue Serv., *Selected Historical and Other Data*, 22 STATISTICS OF INCOME BULL. 244-45 tbl.18 (Spring 2003).

<sup>165</sup> See, e.g., Andrew Mitrusi & James Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979-99*, 53 NAT'L TAX J. 765, 770 (2000).

<sup>166</sup> This attribution is based on the theory that the taxes affect the way capital is allocated between the corporate and noncorporate sectors of the economy, which influences the rate of return on all capital. See generally JANE G. GRAVELLE & KENT SMETTERS, WHO BEARS THE BURDEN OF THE CORPORATE TAX (AND WHY?): THE OPEN ECONOMY CASE (Cong. Budget Office, Technical Paper No. 1998-1, 1998), available at <ftp://ftp.cbo.gov/31xx/doc3123/19981.pdf>. Not all economists agree with this assumption. Some economists conclude that as little as 40% of the corporate tax burden is borne by domestic capital. VICTOR R. FUCHS ET AL., WHY DO ECONOMISTS DISAGREE ABOUT POLICY? THE ROLE OF BELIEFS ABOUT PARAMETERS AND VALUES 12-13 (Nat'l Bureau of Econ. Research, Working Paper No. 6151, 1997). The Joint Committee on Taxation does not allocate the corporate tax burden, on the grounds that the distribution is too uncertain. See CONG. BUDGET OFFICE, *supra* note 6, at 56.

households according to their consumption of taxed goods (tobacco and alcohol) or—in the case of excise taxes that affect intermediate goods—in proportion to overall consumption. Under this analysis, corporate taxes fall more heavily on taxpayers in the higher-income classes; social insurance tax rates are higher for the middle-income classes; and excise taxes fall disproportionately on low-income households.<sup>167</sup>

#### a. Payroll Taxes

Most households pay a larger amount in payroll taxes than in income taxes. As previously explained, economists generally agree that even though the employer nominally pays one-half of total payroll taxes, the entire burden is borne by employees.<sup>168</sup> Taking into account both the employers' and employees' shares of payroll taxes, 70% or more of households have paid more in payroll taxes than in income taxes, and that has been true for every income category below the top quintile since 1988.<sup>169</sup> Payroll taxes are regressive because they are based on a flat rate and for the most part are subject to a ceiling. According to the CBO data, effective wage tax rates are lower for the top quintile than for any other income class.

The overall effective payroll tax rate increased fairly steadily from 1979 to 1994, as Congress increased the levies to deal with financing Social Security and Medicare. Since 1994, however, the overall effective payroll tax rate has been falling, as an increasing percentage of

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<sup>167</sup> See CONG. BUDGET OFFICE, *supra* note 23, at 9.

<sup>168</sup> Economists widely agree that the burden of the payroll tax, including the employer's share is borne by the workers. See STAFF OF JOINT COMM. ON TAXATION, 103D CONG., *METHODOLOGY AND ISSUES IN MEASURING CHANGES IN THE DISTRIBUTION OF TAX BURDENS* 41 (JCS-7-93) (Comm. Print 1993), *citing* JOSEPH A. PECHMAN & BENJAMIN A. OKNER, WHO BEARS THE TAX BURDEN? 24–37 (1974); JOSEPH PECHMAN, *supra* note 130, at 223–25. See generally Richard A. Kasten & Eric J. Toder, *CBO's Methodology for Distributional Analysis*, in *DISTRIBUTIONAL ANALYSIS OF TAX POLICY*, *supra* note 117, at 120; James R. Nunns, *OTA's Methodology for Distributional Analysis*, in *DISTRIBUTIONAL ANALYSIS OF TAX POLICY*, *supra* note 117, at 111. The reason that employees bear the employer's share of the FICA tax is that before-tax wages are depressed by the amount of the tax. Most wage earners, however, are blissfully unaware of this economic truth.

<sup>169</sup> See CONG. BUDGET OFFICE, *supra* note 23, at 2–3, 9. If only the employee's share of payroll taxes is taken into account, a method which probably matches popular perception, if not economic reality, between 41% and 45% of households pay more in payroll taxes than in income taxes, depending on whether households that pay income taxes but not payroll taxes (because all of the income is from capital) are taken into account. Still, even by this measure, over 90% of households in the lowest-income quintile, over 70% of households in the second income quintile, and over between 40% and 48% of households in the middle income quintile pay more in payroll taxes than in income taxes. See Mitrusi & Poterba, *supra* note 165, at 765.

total income, mostly realized by the highest income households, is not subject to payroll taxes or is above the ceiling for the Social Security portion of the payroll taxes. Effective payroll tax rates for 1979, 1994 (the peak overall payroll tax rate), and 2000 were as shown in the following Table.

Effective Payroll Tax Rates, 1979, 1994, 2000 <sup>170</sup>			
<i>Income Category</i>	<i>1979</i>	<i>1994</i>	<i>2000</i>
Lowest Quintile	5.3	7.2	8.2
2d Quintile	7.7	8.9	9.4
3d Quintile	8.6	9.5	9.6
4th Quintile	8.5	10.2	10.4
5th Quintile	5.4	7.5	6.3
<b>Overall</b>	<b>6.9</b>	<b>8.6</b>	<b>7.9</b>
Top 10%	4.2	6.3	5.0
Top 5%	2.8	4.9	3.8
Top 1%	0.9	2.6	1.9

Effective wage tax rates have been higher than effective income tax rates for households in the first four quintiles for every year since 1984, and for households in the first three quintiles in all years of the CBO studies, and have continuously risen.<sup>171</sup> Because of the inherent structure of the payroll taxes, the highest income cohorts have experienced the lowest percentage point increases in effective rates.

In analyzing overall tax burdens, payroll taxes properly are taken into account for two reasons. First, the relationship between payroll taxes paid and Social Security and Medicare benefits received is very tenuous.<sup>172</sup> Second, as already noted, since 1983 payroll taxes have been set at a level that is significantly more than adequate to fund the Social Security system and Medicare on a pay-as-you-go basis, and the excess revenue from payroll taxes funds general expenditures. In this regard, it is important to note that, these “excess” payroll tax receipts made the most significant contribution to the transitory surplus of the late 1990s that was “returned to the taxpayers” by the Bush tax cuts of 2001 and 2003. The “refund,” however, did not go to the taxpayers who paid the payroll taxes; most of the “refund” went to the top 1 % of the income pyramid.

<sup>170</sup> See CONG. BUDGET OFFICE, *supra* note 23, at 22–23 tbl.B-1A.

<sup>171</sup> See *id.*

<sup>172</sup> See PECHMAN, *supra* note 130, at 227–28.

## b. Corporate Taxes

Corporate taxes are important to progressivity because corporate taxes are borne disproportionately by high-income taxpayers. As noted previously, the CBO studies treat corporate taxes as borne by owners of capital and allocate corporate taxes to households in proportion to their income from interest, dividends, rents, and capital gains.<sup>173</sup> Under this assumption, high-income households bear a disproportionately large share of the burden of corporate taxes, and the tax is highly progressive.<sup>174</sup> A decline in the effective corporate tax rate benefits high-income households more than other households.<sup>175</sup>

The percentage of total federal taxes represented by corporate income tax collections has fallen dramatically in the last forty years. Prior to 1968, corporate tax receipts consistently represented more than 20% of total federal taxes. Corporate income taxes fell below 10% of total federal tax receipts for the first time after the 1981 Act, which significantly reduced the statutory rates and provided much more generous cost recovery allowances (depreciation) than had previously been allowed. Through much of the 1990s, corporate tax receipts hovered around 11.5% of total federal taxes, before dropping back to about 10% in the last years of the twentieth century. In the first years of the twenty-first century, corporate income taxes plunged to 8% or less of total federal taxes.<sup>176</sup>

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<sup>173</sup> CONG. BUDGET OFFICE, *supra* note 6, at 3–4 (“CBO considered the taxes to be borne by owners of capital under the assumption that the taxes affect the way capital is allocated between the corporate and noncorporate sectors of the economy, which influences the rate of return on all capital.”).

<sup>174</sup> Economists believe that international flows of capital make it possible that the burden of corporate taxes can be shifted to workers, but this argument is “highly controversial.” See JOEL SLEMMOD & JON BAKIJA, *TAXING OURSELVES, A CITIZENS GUIDE TO THE GREAT DEBATE OVER TAX REFORM* 67–69 (1996).

<sup>175</sup> CONG. BUDGET OFFICE, *supra* note 6, at xxi–xxii.

<sup>176</sup> OFFICE OF MGMT. & BUDGET, *supra* note 137, at 31–32 tbl.2.2. According to a study published by the Center on Budget and Policy Priorities:

[C]orporate income tax revenues fell to \$132 billion in 2003, down 36 percent from \$207 billion in 2000.

As a result . . . , corporate revenues in 2003 represented only 1.2 percent of the Gross Domestic Product . . . , the lowest level since 1983, the year in which corporate receipts plummeted to levels last seen in the 1930s.

Corporate revenues represented only 7.4 percent of all federal tax receipts in 2003. With the exception of 1983, this represents the lowest level on record (these data go back to 1934).

In part, the decline in the relative importance of the corporate income tax to total tax receipts has been attributable to the increasing relative importance of payroll taxes. But the corporate tax itself has become less burdensome through both rate reductions and erosion of the base, the latter primarily through increasingly generous depreciation deductions.<sup>177</sup> Some analysts also have attributed its decline to the rise of corporate tax shelters in the 1990s,<sup>178</sup> but this proposition remains controversial.<sup>179</sup> Nevertheless, it is undeniable that effective corporate tax rates (measured at the corporate level) have fallen significantly in recent years, even apart from any significant statutory changes.<sup>180</sup> Consequently, effective corporate tax rates measured at the individual level also have fallen.

From 1979 to 2000, the overall effective corporate income tax rate for individuals fell from 3.4% to 2.5%, although the overall rate

Corporate Income Tax Receipts as a Percentage of Total Federal Receipts and GDP, by Decade

Average Percentage of Corporate Taxes as:

	Share of Total Federal Receipts	Share of GDP
1950–1959	27.5%	4.8%
1960–1969	21.3%	3.8%
1970–1979	15.0%	2.7%
1980–1989	9.3%	1.7%
1990–1999	10.5%	2.0%
2000–2009*	9.6%	1.7%

\*Reflects OMB historical data through 2002, Treasury estimates of actual 2003, and CBO projections (August 2003) for the remaining years. The CBO projections assume that existing tax breaks will expire as scheduled and will not be extended. Source: JOEL FRIEDMAN, CTR. ON BUDGET & POLICY PRIORITIES, *THE DECLINE OF CORPORATE INCOME TAX REVENUES 1* (Oct. 24, 2003), available at <http://www.cbpp.org/10-16-03tax.pdf>.

<sup>177</sup> *Id.*

<sup>178</sup> See Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 177 (2002); see also FRIEDMAN, *supra* note 176, at 9–11. See generally STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION CONCERNING INTEREST AND PENALTIES AND CORPORATE TAX SHELTERS BEFORE THE SENATE COMMITTEE ON FINANCE (JCX-23-00) (Comm. Print 2000), available at <http://www.house.gov/jct/x-23-00.pdf>; MIHIR A. DESAI, *THE CORPORATE PROFIT BASE, TAX SHELTERING ACTIVITY, AND THE CHANGING NATURE OF EMPLOYEE COMPENSATION* (Nat'l Bureau of Econ. Research, Working Paper No. 8866, 2002).

<sup>179</sup> See George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1853 (2003) [hereinafter Yin, *Large Public Corporations*]; George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405, 405–07 (2002).

<sup>180</sup> Yin, *Large Public Corporations*, *supra* note 179, at 1852–53 (covering the period 1995 through 2000).

fell to as low as 1.4% in 1982 and rebounded to as high as 2.9% in 1997. Comparison of 1979 and 1982 data for the “all quintiles” category helps to identify the 1981 Act as the key point in the decline of effective corporate tax rates.

Effective Corporate Income Tax Rates, Selected Years 1979–2000 <sup>181</sup>					
<i>Income Category</i>	<i>1979</i>	<i>1982</i>	<i>1988</i>	<i>1997</i>	<i>2000</i>
Lowest Quintile	1.1	0.5	0.07	0.5	0.05
2d Quintile	1.2	0.5	0.08	0.7	0.06
Middle Quintile	1.4	0.7	1.2	1.1	1.0
4th Quintile	1.6	0.7	1.3	1.3	1.0
Highest Quintile	5.7	2.1	3.6	4.4	3.7
All Quintiles	3.4	2.2	2.4	2.9	2.5
Top 10%	7.4	4.6	4.5	5.5	4.5
Top 5%	9.5	5.9	5.5	6.6	5.4
Top 1%	13.8	8.7	7.3	8.7	6.8

As should be expected, most of the benefit of the decline of the corporate income tax inured to the highest-income cohorts—not the top quintile, not even the top 10%, but to the top 5%, and within that small group, mostly to the top 1%, whose effective corporate tax rate was halved. The magnitude of the decline depends on the share of the cohort’s income derived from capital,<sup>182</sup> and the top 5%, and particularly the top 1%, realize a significantly greater proportion of their income as income from capital than do classes lower in the income distribution.<sup>183</sup> The greater reduction in the impact of corporate taxes for the highest-income classes has reduced progressivity.

### c. *Excise Taxes*

Finally, the federal government imposes a variety of excise taxes, for example, gasoline, cigarette, and liquor taxes. Excise taxes claimed a fairly constant share of overall income—at or just under 1%—between 1979 and 2000 despite increases in statutory rates. But that consistent overall rate obscures significantly different effects within different income categories. Members of the lowest quintile first saw excise taxes increase from 1.6% of their income in 1979 to 2.6% in 1994, before dropping back to 2.2% in 2000. In 2000, the second quintile’s effective excise tax rate was 1.4%, while the third

<sup>181</sup> CONG. BUDGET OFFICE, *supra* note 23, at 23–24 tbl.B-1A.

<sup>182</sup> CONG. BUDGET OFFICE, *supra* note 6, at 12.

<sup>183</sup> See Piketty & Saez, *supra* note 42, at 15 tbl.III.

quintile's was 1.2%, both only 0.1 percentage points higher than in 1979. In contrast, the top quintile saw its excise tax rate drop from 0.7% in 1979 to 0.6% in 2000, while the top 1% excise tax rate dropped from 0.05% to only 0.3% over the same period. In short, the continuing overall effect was to make a regressive tax even more regressive.<sup>184</sup> Excise taxes claimed more than five times the share of income from the lowest-income households than they claimed from the highest-income households.<sup>185</sup>

### 3. Total Effective Tax Rate

In the end, what is important from the broadest tax policy perspective is not the progressivity of any one tax, but the progressivity of the tax system. One tax might be changed so as to enhance progressivity, whereas another tax is changed to lessen its progressivity. Neither of the changes standing alone provides an adequate viewpoint for public policy analysis.<sup>186</sup>

In its 1997 study, the CBO concluded that total federal taxes had become more progressive from 1979 to 1997. By this the CBO meant that the federal tax system had served to narrow the gap between taxpayers at the top and taxpayers at the bottom, and that the extent to which it did so had increased over this time period.<sup>187</sup> The CBO analysis was based solely on changes in effective tax rates, because, as the CBO study acknowledges, the before-tax incomes of those at the top of the income pyramid increased so dramatically relative to the incomes

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<sup>184</sup> Excise taxes are considered to be regressive because low-income individuals spend a higher percentage of their income on items subject to excise taxes than do high-income individuals. See PECHMAN, *supra* note 130, at 199–200.

<sup>185</sup> CONG. BUDGET OFFICE, *supra* note 23, at 24–25 tbl.B-1A.

<sup>186</sup> See generally Gene Steuerle, *Can Progressivity of Tax Changes Be Measured in Isolation*, 101 TAX NOTES 1187 (2003). In addition, due consideration must be given to the pattern of government expenditures. As Gene Steuerle has noted, "The only real test of progressivity is whether, on net, there is redistribution from richer to poorer as a result of all the changes on both the tax and spending sides of the budget." *Id.* at 1187. Expenditures that disproportionately benefit lower-income classes, such as, transfer payments to the indigent, are more progressive than those benefits of which are spread more evenly, such as public education, which in turn are more progressive than those that disproportionately benefit higher-income classes, such as subsidies to businesses. Even Social Security and Medicare benefits are not distributed as progressively as many people think. Although within bounds, individuals who had higher wage income in their working years receive higher, though less than proportionately higher, Social Security (but not Medicare) benefits, the benefits programs do not in fact redistribute very much after the higher mortality rates of the poor are taken into account. *Id.* at 1188.

<sup>187</sup> CONG. BUDGET OFFICE, *supra* note 6, at 1–2.

of those further down the pyramid,<sup>188</sup> that the gap in after-tax income between those at the top and those at the bottom actually increased.<sup>189</sup>

The total effective tax rate for selected years between 1979 and 2000, as computed by the CBO, is shown in the following table.

Total Effective Tax Rate, Selected Years, 1979–2000 <sup>190</sup>										
<i>Income Category</i>	1979	1981	1985	1988	1992	1996	1998	1999	2000	<i>% Change 1979–2000<sup>191</sup></i>
1st Quintile	8.0	8.3	9.8	8.5	8.2	5.6	5.8	6.1	6.4	-20.0
2d Quintile	14.3	14.7	14.8	14.3	13.7	13.2	13.0	13.3	13.0	-9.09
3d Quintile	18.6	19.2	18.1	17.9	17.4	17.3	16.8	16.9	16.7	-10.22
4th Quintile	21.2	22.1	20.4	20.6	20.2	20.3	20.4	20.5	20.5	-3.3
Highest Quintile	27.5	26.9	24.0	25.6	25.6	28.0	27.6	28.0	28.0	+1.82
All Quintiles	22.2	22.4	20.9	21.8	21.5	22.7	22.6	22.9	23.1	+4.05
Top 10%	29.6	28.2	24.7	26.7	26.9	30.1	29.3	29.7	29.7	+0.35
Top 5%	31.8	29.4	25.4	27.8	28.1	32.0	30.8	31.2	31.1	-2.2
Top 1%	37.0	31.8	27.0	29.7	30.6	36.0	33.4	33.5	33.2	-10.27

These data indicate that any increased progressivity was only with respect only to the bottom 60% of the income pyramid vis-à-vis the 61st through the 99th percentile. There was no increase in progressivity vis-à-vis the top 1%. That small cohort saw a greater reduction in effective tax rates than any cohort other than the bottom quintile. Even the conclusion that there was increased progressivity with respect to the bottom 60% vis-à-vis the 61st through the 99th percentile is questionable, however, given that the effective tax rates of the higher-income cohorts increased not through statutory changes, but because their before-tax incomes, which increased by higher percentages than did the lower-income cohorts, pushed portions of their income increments into higher marginal tax brackets.<sup>192</sup>

<sup>188</sup> See *supra* notes 23–32 and accompanying text.

<sup>189</sup> See *supra* notes 76–83 and accompanying text.

<sup>190</sup> CONG. BUDGET OFFICE, *supra* note 23, at 22–23 tbl.B-1A.

<sup>191</sup> Calculations made by author.

<sup>192</sup> See *supra* notes 187–190 and accompanying text.



The study by Petska, Strudler, and Petska concludes that the individual income tax significantly contributed to the declining total effective tax rates at the top of the income distribution.<sup>193</sup> In contrast to the CBO, however, they conclude that average income tax rates for the top 1% of the income distribution decreased substantially from 1979 to 2000, with the top 0.10% of taxpayers seeing the largest decrease.<sup>194</sup> They find changes in the trends for average tax rates can be divided into four distinct periods.<sup>195</sup> First, prior to the 1981 Act, average tax rates were climbing, primarily due to bracket creep. Second, from 1982 through 1992, average tax rates generally declined for most income classes, with the most marked decline for the top 0.10%. Third, average tax rates for the top quintile—mostly the top 10%—increased as the 31%, 36%, and 39.6% brackets took effect in the early 1990s. Finally, average tax rates fell for the top two quintiles—most markedly again for the top 1% and top 0.10%—after the reduction of capital gains rates in 1997.

Trying to discern the effect on progressivity of these changes in effective rates is difficult. Some comparisons indicate that progressivity has increased since 1979. Using the CBO data, in 1979, the effective tax rate for the top 1% was 4.625 times the effective rate for the lowest quintile, and by 2000, it had climbed to almost 5.2 times the effective rate for the lowest quintile. On the other hand, in 1979, the effective tax rate for the top 1% was just under twice the effective rate for the middle quintile, and by 2000, it had remained at just under twice the effective rate for the middle quintile. In 1979, the effective tax rate for the middle quintile was 2.325 times the effective rate for the lowest quintile, and by 2000, it had increased to approximately 2.61 times the effective rate for the lowest quintile. These comparisons suggest that progressivity increased at the lower end of the income scale, but not at the upper end. Comparison of percentage decreases in rates confirms that the reduction of effective tax rates for the lowest quintile, all of which occurred in the late 1990s—virtually all of which resulted from expansion of the earned income credit and the enactment of the refundable child credit—increased progressivity at the lower end of the income distribution. Furthermore, progressivity measured by comparing the second and third quintiles as a group with the fourth and fifth quintiles, as a group, increased. But focusing

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<sup>193</sup> Petska et al., *supra* note 9, at 342 tbl.5.

<sup>194</sup> *Id.* at 346–47 tbl.5 (percentage calculations made by author of percentage reduction in rates shown in Table 5); see *supra* notes 165–166 and accompanying text.

<sup>195</sup> Petska et al., *supra* note 9, at 347.

on progressivity at the very top of the income pyramid, by comparing the top 1% with the second, third, fourth, and fifth quintiles (exclusive of the top 1%) as a group, reveals that progressivity markedly decreased between 1979 and 2000.<sup>196</sup> Moreover, most of that decline occurred in the early 1980s, following the dramatically disproportionate tax cuts accorded to the very highest-income taxpayers and the corporate tax cuts in the 1981 Act.

Another method for examining overall changes in progressivity is based on analysis of changes in the Gini index. The Gini coefficient is a measure of the degree of income inequality; a higher Gini value represents greater income inequality.<sup>197</sup> Changes in progressivity between two points in time can be measured by comparing changes in the before-tax Gini index and changes in the after-tax Gini index. If the percentage difference between the before-tax Gini index and the after-tax Gini index increases, progressivity has increased. Conversely, if the percentage difference between the before-tax Gini index and the after-tax Gini index decreases, progressivity has decreased.

Petska, Strudler, and Petska's study provides a very revealing analysis of changes in the Gini index.<sup>198</sup> Their analysis shows the be-

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<sup>196</sup> Even if the 10.27% reduction in the overall effective tax rate for the top 1% was matched by the other quintiles, the effect would have been to reduce progressivity. Across-the-board equal percentage reductions in tax rates (for example, a 10% reduction in all rates—for instance, 30% to 27%, 20% to 18%, and 10% to 9%) reduces progressivity. As it was, only the first and third quintiles had rate reductions equal to or greater than that of the top 1%. See GRAVELLE, *supra* note 116, at 8–9.

<sup>197</sup> The Gini index ranges from zero, indicating perfect equality (when everyone receives an equal share of income), to one, indicating perfect inequality (when all the income is received by only one recipient). Numerically, a Gini coefficient is the estimated area above a Lorenz curve but beneath the 45° diagonal, expressed as a percentage of the entire area below the 45° diagonal. A Lorenz curve is a cumulative aggregation of income from lowest to highest, expressed on a percentage basis. The 45° diagonal represents absolute equality of income. The curve of actual distribution is below and to the right of the 45° diagonal. If between two points in time inequality has increased, the curve for actual distribution shifts to the right, the area between the curve showing actual distribution and the 45° diagonal increases, and the Gini index goes up. Conversely, if between two points in time inequality has decreased, the curve for actual distribution shifts to the left, the area between the curve showing actual distribution and the 45° diagonal decreases, and the Gini index goes down. The Census Bureau calculates and publishes detailed Gini indices using a variety of definitions of income. The CBO studies of Effective Federal Tax Rates did not include any Gini index analysis.

Reliance on changes in the Gini index alone can hide issues. Two Lorenz curves may intersect when there has been a change in distribution that reflects increasing downside inequality, for example, if the poor lose ground to the middle class, but the middle class gains ground on the upper class. See generally James Davies & Michael Hoy, *Making Inequality Comparisons When Lorenz Curves Intersect*, 85 AM. ECON. REV. 980 (1995).

<sup>198</sup> See Petska et al., *supra* note 9, at 346–47 tbl.5.

fore-tax Gini index climbing from 0.469 in 1979 to 0.588 in 2000, with the biggest jumps coming in the periods 1981 to 1988 and 1994 to 2000.<sup>199</sup> The after-tax Gini index, although always lower than the before-tax Gini index, thus demonstrating that the federal tax system is indeed progressive, likewise increased between 1979 and 2000. The largest differences were prior to the 1981 Act, with the percentage difference falling to its lowest point in 1991. There was a significant increase in the difference from 1992 to 1993. The post-1981 peak in the difference, which was well below the pre-1982 peak in the differences between the pre-tax and post-tax Gini indices was reached in 1996, before the difference began to fall again in 1997. The difference remained relatively flat through 2000.<sup>200</sup> This pattern confirms what one might expect—that the tax system has been relatively more progressive in years of higher marginal rates and relatively less progressive in years in which the highest marginal rates on highest-income earners were lower. The post-1996 dip also indicates that reductions in capital gains rates reduce progressivity.

#### 4. Isolating the Effect of Statutory Rules

For reasons explained earlier in this Part, analysis of effective tax rates does not necessarily accurately illustrate the effect on tax burdens of statutory changes. As the distribution of incomes shifts upward and as the composition of income within income classes changes, effective tax rates change without any change in statutory rates. Thus, effective rate analysis does not completely capture the impact of policy decisions reflected in tax legislation. Isolating the impact of changes in the statutory structure, including rate schedules, requires computer simulations of tax liabilities for different years under the law as in effect for that year but using the income from only one of the years. One such study by Andrew Mitrusi and James Poterba paints a very different picture of the changing progressivity of the federal tax system than the one

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<sup>199</sup> *Id.* at 349 fig.G. The Census Bureau before-tax Gini index, which omits capital gains and thus understates income inequality, also shows a similar increase in inequality over that period, although the numerical values of the index differ. See U.S. CENSUS BUREAU, *Gini Ratios for Households, by Race and Hispanic Origin of Householder: 1967 to 2001*, in HISTORICAL INCOME TABLES tbl.H-4 (2004), <http://www.census.gov/hhes/income/histinc/h04.html> (last revised Aug. 27, 2004); U.S. CENSUS BUREAU, *Gini Ratios for Families, by Race and Hispanic Origin of Householder: 1947 to 2001*, in HISTORICAL INCOME TABLES tbl.F-4 (2004), <http://www.census.gov/hhes/income/histinc/f04.html> (last revised July 8, 2004).

<sup>200</sup> If the 2001 tax cut sent as rebate in 2000 is treated as a reduction in taxes for 2000, the progressivity of the tax system increased somewhat from 1999 to 2000, but still did not even reach its 1996 level. Petska et al., *supra* note 9, at 349 fig.G.

painted by the CBO.<sup>201</sup> On an overall basis, the changes in the structure of the federal tax system in the last decades of the twentieth century not only did nothing to mitigate the growing disparity in incomes, but in fact contributed to it.

According to Mitrusi and Poterba, 62.6% of families that paid both income taxes and payroll taxes had lower personal income tax liabilities in 1999 than they would have had if the 1979 law had still been in effect, but only 36.4% saw a decline in combined income and payroll tax liabilities.<sup>202</sup> Strikingly, most families at low-income levels experienced a combined payroll and income tax increase between 1979 and 2000. Only at income levels above \$50,000 did a majority of families see a reduction in combined income and payroll taxes.<sup>203</sup> Less than 20% of families with incomes below \$10,000—roughly 25.5% of all filers<sup>204</sup>—had either an income tax reduction or a reduction in combined income and payroll taxes. Only 45% of families with incomes between \$10,000 and \$20,000—another 18.9% of all returns—had an income tax reduction, and only 30.1% of that group saw a reduction in combined income and payroll taxes. Seventy-eight percent of returns in the \$20,000 to \$30,000 category—another 14.5% of all filers—had an income tax reduction, but only 34.5% of families in that group had a reduction in combined income and payroll taxes. On the other hand, nearly 90% of filers with an income between \$500,000 and \$1 million, and over 90% of filers with an income exceeding \$1 million saw a reduction in both income taxes and combined income and payroll taxes.

The picture is clear. The marketplace for before-tax income is increasingly becoming a winner-take-all market, and Congress loves a winner. Those who win in the marketplace likewise win in the legislative halls. As the rich have gotten richer, Congress has continually cut their

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<sup>201</sup> See Mitrusi & Poterba, *supra* note 165, at 782 (computing percentages of families that paid less taxes—that is, income, payroll, and combined income and payroll taxes—in 1999 than they would have paid if the 1979 law had still been in effect).

<sup>202</sup> *Id.* at 778–79. If the analysis considers families that had either income taxes and payroll taxes (but not necessarily both), 70.2% had lower personal income tax liabilities in 1999 than they would have had if the 1979 law had still been in effect, and only 37.5% saw a decline in combined income and payroll tax liabilities.

Among the many statutory changes that contribute to these effects in addition to the statutory rate changes, one of the most important changes for low-income taxpayers is the significant expansion of the earned income credit.

<sup>203</sup> Incomes are adjusted gross income ("AGI").

<sup>204</sup> See David Campbell & Michael Parisi, Internal Revenue Serv., *Individual Income Tax Returns, 1999*, 21 STATISTICS OF INCOME BULL. 9, 26 tbl.1 (Fall 2001), available at <http://www.irs.gov/pub/irs-soi/99indtr.pdf>. Calculations made by author based on data therein.

taxes, and their tax cut has been relatively larger than those accorded to most income classes lower on the income pyramid. From the mid-1990s until the turn of the millennium, only the rich have seen a decrease in their effective tax rates. The Matthew Effect is pervasive.

#### IV. TAX POLICY IN THE NEW MILLENNIUM

##### A. *The Legacy of the Roaring Nineties*

At the dawn of the new millennium in the United States, the regular individual income tax had five marginal tax brackets as follows: 15%, 28%, 31%, 36%, and 39.6%. The upper and lower parameters of each bracket were statutorily specified in terms of 1992 dollars, and the brackets were, and continue to be, adjusted for inflation.<sup>205</sup>

The regular income tax was, and continues to be, backstopped by the alternative minimum tax (the "AMT"). The AMT was first enacted in 1969 to limit the ability of high-income taxpayers to eliminate virtually all tax liability through the benefit of various tax preferences, generally speaking, provisions enacted to promote economic and social goals (primarily those provisions classified as "tax expenditures"), rather than to measure net income. Generally speaking, the AMT has a broader base than the regular tax and rates lower than the highest regular tax rates but higher than the lower regular tax rates. Five deductions, most of which are "personal" in nature and not the result of tax planning involving tax preferences aimed at business and investment—the original target of the AMT, which are allowed under the regular tax, are not allowed under the AMT. These deductions—personal exemptions, standard deductions, state and local tax deductions, medical expense deductions, and miscellaneous itemized deductions—collectively comprise about three-quarters of individual AMT preferences and adjustments.<sup>206</sup> All of these adjustments were added into the AMT base in the 1986 Act. Since 1992, the AMT rate has been 26% on the first \$175,000 over the exemption amount and 28% on the excess over that amount. The exemption amount was \$45,000 for married taxpayers filing a joint return and \$33,750 for single taxpayers. Unlike the regular tax, in which exemptions, the

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<sup>205</sup> The actual dollar-denominated range of each tax bracket is announced annually in a Revenue Procedure.

<sup>206</sup> Medical expense deductions are not completely disallowed under the AMT, but are subject to a floor equal to 10% of AGI rather than the normal 7.5% floor.

standard deduction, and rate brackets are indexed for inflation. the AMT rate brackets and exemption are not indexed for inflation.<sup>207</sup>

Studies indicate that, by 2007, almost 95% of the revenue from AMT preferences and adjustments will be derived from the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions.<sup>208</sup> As a result, the AMT increasingly affects middle-income wage earners—taxpayers not engaged in tax-shelter or deferral strategies. In 2000, the percentage of taxpayers, grouped by AGI, who were liable for the AMT peaked in the range from \$100,000 to \$200,000. At the higher-income levels, however, the percentage of taxpayers liable for the AMT steadily dropped. By 2010, the percentage of taxpayers liable for the AMT is projected to become significant in the \$50,000 to \$75,000 range, to peak in the \$200,000 to \$500,000 range, and thereafter to decline steeply.<sup>209</sup> A recent study by the Treasury Department suggests that, by 2010, 17 million individual taxpayers, nearly 16% of all taxpayers, will be subject to the AMT.<sup>210</sup> In 2001, the Staff of the Joint Committee on Taxation estimated that, by 2010, 16.4 million taxpayers, many of whom Congress never intended to be subject to the AMT, nevertheless will be liable for the AMT.<sup>211</sup> Subsequent legislation might have changed the precise magnitude of the projections, but the trend has not been substantially affected. More recently, in 2003, the National Taxpayer Advocate reported that the Staff of the Joint Committee on Taxation has estimated that the AMT will affect 12.7 million taxpayers in 2005 and about 32 million in 2010.<sup>212</sup> Because the individual AMT so widely misses its original mark, while adding inordinate complexity to the tax system for mid-

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<sup>207</sup> Like the regular tax, AMT exemptions are phased out at higher-income levels. The phase-out range generally is between \$155,000 and \$330,000 for a married couple filing jointly and between \$112,500 and \$247,500 for single taxpayers.

<sup>208</sup> See Robert P. Harvey & Jerry Tempalski, *The Individual AMT: Why It Matters*, 50 NAT'L TAX J. 453, 468 (1997).

<sup>209</sup> See Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 TAX NOTES 1455, 1456 (2001).

<sup>210</sup> See generally ROBERT REBELEIN & JERRY TEMPALSKI, WHO PAYS THE INDIVIDUAL AMT? (Office of Tax Analysis, U.S. Treasury Dep't, OTA Paper No. 87, 2000), available at <http://www.treas.gov/ota/ota87.pdf>.

<sup>211</sup> STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., 1 STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 10 (JCS-3-01) (Comm. Print 2001), available at <http://www.house.gov/jct/s-3-01vol1.pdf>.

<sup>212</sup> See generally NAT'L TAXPAYER ADVOCATE SERV., INTERNAL REVENUE SERV., 2003 ANNUAL REPORT TO CONGRESS (2003) (citing unpublished data provided by the Joint Committee on Taxation), available at [http://www.irs.gov/pub/irs-utl/nta\\_2003\\_annual\\_update\\_mcw\\_1-15-042.pdf](http://www.irs.gov/pub/irs-utl/nta_2003_annual_update_mcw_1-15-042.pdf).

dle-income wage earners due to its interaction with limitations on the various personal credits, there is growing sentiment for its repeal, even among those policy analysts who originally supported the enactment of the individual AMT.<sup>213</sup> In the political arena, however, there is no major initiative for AMT relief.<sup>214</sup>

## B. *The Republican Tax Relief Agenda*

### 1. The Economic Growth and Tax Relief Reconciliation Act of 2001

In 2001 there was a Republican president and Republican control of both houses of Congress for the first time since the early 1950s. In a highly partisan vote, Congress quickly enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"), which in large part fulfilled the campaign promises of President George W. Bush. The changes in this Act were intended to reduce tax revenues by \$1.35 trillion during the period from 2001 through 2010.<sup>215</sup> The most significant provisions of the 2001 Act were a substantial reduction in income tax rates and the complete repeal of the federal estate tax. To reduce the immediate budgetary impact of the drastic rate reductions, most of the income tax rate reductions were scheduled to be phased in over five years, to take full effect in 2006. All of the rate brackets above 15% were to be reduced according to the following schedule.

Rate Bracket Reductions				
Taxable Year	Rate to Be Substituted in § 1 for the 2000 Rates			
	28%	31%	36%	39.6%
2001	27.5%	30%	35%	39.1%
2002 & 2003	27%	30%	35%	38.6%
2004 & 2005	26%	29%	34%	37.6%
2006 & Thereafter	25%	28%	33%	35%

<sup>213</sup> The Staff of the Joint Committee on Taxation has recommended its repeal. STAFF OF JOINT COMM. ON TAXATION, *supra* note 211, at 15–16.

<sup>214</sup> President Bush's tax proposals in the 2005 Budget provide only minimal AMT relief. See generally Leonard E. Burman et al., *AMT Relief in the FY2005 Budget: A Bandaid for a Hemorrhage* (Feb. 4, 2004), available at <http://www.urban.org/UploadedPDF/1000601.pdf>.

<sup>215</sup> JOINT COMM. ON TAXATION, 107TH CONG., ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 1836: FISCAL YEARS 2001–2011, at 8 (JCX-51-01) (Comm. Print 2001), available at <http://www.house.gov/jct/x-51-01.pdf>.

In addition, a new initial 10% marginal rate bracket was carved out of the previously lowest 15% rate bracket, which was not reduced.<sup>216</sup> The 10% rate bracket applied to the first \$12,000 of taxable income for married taxpayers filing a joint return (\$14,000 after 2007), and \$6000 for single taxpayers (\$7000 after 2007). Even this rate reduction, however, was not targeted to the bottom of the income pyramid. Millionaires received as much or more benefit than most taxpayers in the first two quintiles. Most taxpayers in the first quintile already had little or no income tax liability as a result of personal exemptions, the standard deduction, and the earned income credit.<sup>217</sup> The same was true for many taxpayers in the second quintile, in which the earned income credit, as well as the child credit, also provided substantial relief.

The 2001 Act also provided relief from the so-called "marriage penalty." To this end the Act increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The increased standard deduction was to be phased in over five years beginning in 2005 and would be fully effective for 2009 and thereafter. The 2001 Act also increased the upper limit of the 15% income tax rate bracket for a married couple filing a joint return to twice the amount applicable to an unmarried individual filing a single return. This change was to be phased in over four years, beginning in 2005, to be fully effective in 2008.

Although the expansion of the upper limit of the 15% bracket might at first blush appear to provide tax relief for the middle class, it is not in fact so. Expansion of the 15% bracket provides no benefit for taxpayers who were not subject to tax at any rate above 15%, but mainly benefits high-income taxpayers.<sup>218</sup> For 2000, about 70% of taxpayers with some tax liability were in the 15% bracket.<sup>219</sup> Thus, only 30% of taxpayers—the top 30%—benefited at all from this change. When the smoke cleared, it looked like 72% of all taxpayers who filed returns and 64% of all taxpayers who had positive tax liability did not

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<sup>216</sup> For 2001, I.R.C. § 6428 provided a rate reduction credit in lieu of the 10% rate bracket.

<sup>217</sup> See generally Adam Carasso, *How the 2001 and 2003 Tax Cuts Affect Hypothetical Families in Tax Year 2003*, available at [http://www.taxpolicycenter.org/UploadedPDF/410909\\_TaxCuts.pdf](http://www.taxpolicycenter.org/UploadedPDF/410909_TaxCuts.pdf) (last visited Nov. 15, 2004).

<sup>218</sup> GRAVELLE, *supra* note 116, at 8–9.

<sup>219</sup> *Id.* at 2–3.



see any decrease in marginal rates, although they did see some decrease in average rates.<sup>220</sup>

Even the rate reductions aimed solely at the top 30% or so were structured to benefit the higher-income classes. The 39.6% bracket was reduced by 11.62%, the 36% bracket by 8.33%, the 31% bracket by 9.68%, and the 28% bracket by 10.71%. The pattern is somewhat random, but it is clear that the highest marginal tax bracket received the greatest percentage decrease. Even a flat across-the-board percentage rate reduction would have been anti-progressive.<sup>221</sup> Across-the-board percentage cuts increase inequality in after-tax income because they reduce taxes of higher-income taxpayers proportionately more than taxes of lower-income taxpayers.<sup>222</sup> For a tax cut to be distributionally neutral it must increase everyone's after-tax income by the same percentage.<sup>223</sup> The 2001 Act did not do that.<sup>224</sup> Furthermore, the regular tax cuts for much of the top 30%—particularly those with incomes between \$75,000 and \$1 million—were substantially offset by increased AMT liability.<sup>225</sup>

Not all of the targeted tax relief in the 2001 Act went to the highest-income classes. There was some mitigation of anti-progressive rate changes through "targeted" tax cuts.<sup>226</sup> The 2001 Act also increased the amount of the child credit under I.R.C. § 24 from \$500 to \$1000, with the increase to be phased in over ten years—\$600 in 2001 through 2004, \$700 in 2005 through 2008, \$800 in 2009, and \$1000 in 2010. The I.R.C. § 24 child credit is allowed with respect to each of a taxpayer's dependent children under age 17. As originally enacted, the child credit generally was not refundable to the extent that it exceeded the taxpayer's income tax liability.<sup>227</sup> Because the child credit was intended by Congress to benefit the "middle class," it is phased out by \$50 for each \$1000 (or fraction thereof) by which the taxpayer's "modified AGI" exceeds \$110,000 in the case of joint returns

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<sup>220</sup> William G. Gale & Samara R. Potter, *The Bush Tax Cut: One Year Later*, POLICY BRIEF No. 101 (Brookings Inst., Wash., D.C.), June 2002, at 4, available at <http://www.brookings.edu/comm/policybriefs/pb101.pdf>.

<sup>221</sup> An across-the-board percentage rate reduction would reduce all rates by the same percentage of the pre-reduction rate, not by the same number of percentage points.

<sup>222</sup> GRAVELLE, *supra* note 116, at 6–8.

<sup>223</sup> Gale & Potter, *supra* note 220, at 3.

<sup>224</sup> See *supra* notes 218–219 and accompanying text.

<sup>225</sup> See *infra* notes 229–231 and accompanying text.

<sup>226</sup> See GRAVELLE, *supra* note 116, at 12–14.

<sup>227</sup> I.R.C. § 26. For the child credit generally, see BITTKER, McMAHON & ZELENAK, *supra* note 126, at § 27.03.

(\$55,000 in the case of married taxpayers filing separately) and \$75,000 for unmarried taxpayers (who in all likelihood will file under head of household status).<sup>228</sup>

The 2001 Act allowed partial refundability of the child credit. For 2001 through 2004, the credit is refundable to the extent of 10% of the taxpayer's earned income in excess of \$10,000 (indexed for inflation beginning in 2002). After 2005, the percentage increases to 15%.<sup>229</sup> If a taxpayer has three or more children, the credit is refundable to the extent that the taxpayer's Social Security taxes exceed the sum of any other nonrefundable credits plus the taxpayer's earned income credit, if that amount exceeds the amount otherwise refundable. Generally speaking, this last rule means that otherwise unusable child credits are available to obtain a refund of Social Security taxes. In addition, the 2001 Act allowed the child credit to be claimed against the AMT. At the lowest end of the income scale, the 2001 Act expanded the earned income tax credit<sup>230</sup> by raising the threshold and ceiling on the earned income tax credit phase-out by \$1000 for 2002 through 2004, \$2000 for 2005 through 2007, and \$3000 after 2007 (adjusted annually for inflation after 2008).

A glaring omission in the 2001 legislation was any substantial reform of the individual AMT. The regular tax deductions added back to alternative minimum taxable income, including the standard deduction and the personal and dependency exemptions, remained the same. The AMT exemption remained substantially unchanged and remained unindexed for inflation; it was temporarily increased for 2001 through 2004 from \$45,000 to \$49,000 for married taxpayers filing a joint return and from \$33,750 to \$35,750 for single taxpayers.<sup>231</sup> The rates remained the same and the rate brackets continued to be unindexed for inflation. As a result, apart from the temporary partial relief in 2001 through 2004 resulting from a slightly increased exemption amount, many of the middle-class taxpayers who appeared to receive a tax cut under the I.R.C. § 1 rate reductions in fact saw little or no reduction in their income taxes because the reduction in their regular income tax liability gave rise to significant AMT liability for which they

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<sup>228</sup> The phase-out rules create narrow marginal tax brackets as high as 5000%!

<sup>229</sup> Because the partial refundability rules were enacted by the 2001 Act, and all of the amendments in the 2001 Act sunset on December 31, 2010, absent further congressional action, the nonrefundability rule will apply again starting in 2011.

<sup>230</sup> I.R.C. § 32. For a discussion of the earned income credit generally, see BITTKER, McMAHON & ZELENAK, *supra* note 126, at § 27.02.

<sup>231</sup> There were minor adjustments made to the phase-out rules.

had not theretofore been liable.<sup>232</sup> Pulitzer Prize winning *New York Times* investigative tax reporter David Cay Johnston has described the combination of the widely touted regular income tax cuts with the continuation of a substantially unchanged AMT as follows:

The design of the Bush tax cuts made sure that the very rich, those making \$1 million or more per year, got nearly the full measure of the cuts that candidate Bush promised. Not so those making less. To hold the cost of the tax cuts to 1.3 trillion over the first ten years, someone had to lose out. The administration could have decided to cut the top rate of 39.6 percent to 36 percent instead of 35 percent, for example. It could have revised the alternative minimum tax to make it fall more heavily on the very rich so that those making less than \$1 million or \$500,000 could be exempted. Instead, the administration relied on the stealth approach of letting the alternative tax silently take back from those making less than \$500,000 a year some or all of what they were told to expect. This design meant that the upper middle class, families making \$75,000 to \$500,000, would subsidize the tax cuts for those in the million-dollar-and-up income class.<sup>233</sup>

The most dramatic provision in the 2001 Act, however, did not involve income taxes at all, and was a bonanza for the super-rich. The federal government has imposed estate taxes—a tax on the wealth passing from a decedent to the decedent's heirs and legatees—since 1916. The purpose of the estate tax is not primarily to raise revenue.<sup>234</sup> It is “antidynastic.”<sup>235</sup> The purpose of the estate tax is to reduce

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<sup>232</sup> See Jerry Tempalski, *The Impact of the 2001 Tax Bill on the Individual AMT*, in PROCEEDINGS OF THE 94TH ANNUAL NATIONAL TAX ASSOCIATION CONFERENCE ON TAXATION 340, 340–41 (2001).

<sup>233</sup> DAVID CAY JOHNSTON, PERFECTLY LEGAL 110 (2003).

<sup>234</sup> Estate and gift tax collections were only \$11.5 billion in 1990, increasing to \$29 billion in 2000, before falling off to \$22 billion in 2003. OFFICE OF MGMT. & BUDGET, *supra* note 137, at 43–44 tbl.2.5. This is barely 1% of federal revenues. Nevertheless, as the late Senator Everett Dirksen is reputed to have said, “A billion here, a billion there, and pretty soon you’re talking real money.” Whether Senator Dirksen ever actually uttered these words is an open question. DIRKSEN CONG. CTR., “A BILLION HERE, A BILLION THERE . . .,” at [http://www.dirksencenter.org/print\\_emd\\_billionhere.htm](http://www.dirksencenter.org/print_emd_billionhere.htm) (last visited Nov. 15, 2004).

<sup>235</sup> C. Eugene Steuerle, *Comment*, in RETHINKING ESTATE AND GIFT TAXATION 108, 109 (William G. Gale et al. eds., 2001) (commenting on Barry W. Johnson et al., *Elements of Federal Estate Taxation*, in RETHINKING ESTATE AND GIFT TAXATION, *supra*, at 65).

wealth inequality.<sup>236</sup> But the national philosophy apparently changed, and in the 2001 Act Congress repealed the estate tax as of 2010.

Immediately prior to the 2001 Act, the transfer taxes—estate, gift, and generation-skipping taxes—were levied on cumulative lifetime transfers (excluding transfers to spouses and charities) at rates of up to 55%.<sup>237</sup> Generally speaking, the first \$675,000 was tax-free, and that exemption was scheduled to increase in steps to \$1 million by 2006.<sup>238</sup> Through relatively simple tax planning, a married couple could effectively pass double the exemption amount on to the objects of their bounty tax-free.<sup>239</sup>

Although proponents of its repeal described the federal estate tax as a “death tax” and gave the impression that it affected almost everyone,<sup>240</sup> in fact only about 2% of all decedents’ estates have any estate tax liability.<sup>241</sup> Within that small group, slightly less than 10% of the estates—less than 0.2% of all estates, reported over 30% of gross assets and paid over 60% of the total estate tax liability.<sup>242</sup> The estate tax truly is primarily a tax on the super-rich. Furthermore, in large part the estate tax has been a tax on previously untaxed wealth. Despite the popular misperception that the estate tax is an additional levy on after-tax savings, much of the value subjected to the estate tax is unrealized appreciation. Thirty-seven percent of all value in estates above \$500,000 is unrealized capital gains, and, more importantly, among estates valued at more than \$10 million, 56% of value was unrealized capital gains.<sup>243</sup>

Under the 2001 Act, estate tax rates are scheduled to be reduced moderately, and the exemption will be increased significantly, between 2001 and 2009, with the estate tax (and the generation-skipping

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<sup>236</sup> See John Laitner, *Inequality and Wealth Accumulation: Eliminating the Federal Gift and Estate Tax*, in RETHINKING ESTATE AND GIFT TAXATION, *supra* note 235, at 258, 281.

<sup>237</sup> See Johnson et al., *supra* note 235, at 65; see also William G. Gale & Joel Slemrod, *Overview*, in RETHINKING ESTATE AND GIFT TAXATION *supra* note 235, at 1, 6.

<sup>238</sup> Myriad special rules provided lower valuations and deferred payments for farms and closely held businesses.

<sup>239</sup> See generally RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 5.06 (8th ed. 2004).

<sup>240</sup> For a vivid description of the campaign for repeal of the estate tax, see JOHNSTON, *supra* note 233, at 71–91.

<sup>241</sup> Johnson et al., *supra* note 235, at 75.

<sup>242</sup> *Id.* at 76–77.

<sup>243</sup> James M. Poterba & Scott Weisbrenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in RETHINKING ESTATE AND GIFT TAXATION, *supra* note 235, at 422, 439–42.

tax, but not the gift tax) to be completely repealed in 2010.<sup>244</sup> The inevitable result of repeal of the estate tax will be increased inequality of wealth.<sup>245</sup> The rich will be able to pass on unrealized capital gains for generation after generation without the imposition of any tax whatsoever.

For reasons having to do primarily with congressional procedural rules, every provision enacted in the 2001 Act is scheduled to sunset on December 31, 2010. Thus, absent further congressional action, on January 1, 2011, all of the changes implemented by the 2001 Act are automatically repealed, and the Code reverts to its pre-2001 Act provisions. The supporters of these changes never really intended for them to sunset, particularly the repeal of the estate tax, and President Bush's 2005 Fiscal Year Budget proposal calls for making permanent almost all of the temporary provisions in the 2001 Act, including the rate reductions and the repeal of the estate tax.<sup>246</sup>

## 2. Job Creation and Worker Assistance Act of 2002

Later in 2001, following the terrorist attacks of September 11, 2001, Congress enacted the Terrorist Victims Relief Act of 2001, which provided targeted tax relief for victims of the terrorist attacks, and members of their families, and tax incentives for investments in the affected area of lower Manhattan or investments by businesses in that area. Most of the provisions were temporary; only a few permanent provisions affecting victims of future terrorist or military actions were enacted.

The somewhat misleadingly named Job Creation and Worker Assistance Act of 2002 (the "2002 Act")—it was not completely misnamed because it extended unemployment benefits—provided tax cuts for businesses through a series of new and extended accelerated depreciation deductions and credits for business expenses, as well as tax benefits for businesses in New York City affected by the September 11, 2001 terrorist attacks. One of the principal, broadly applicable provisions of the 2002 Act was the addition of I.R.C. § 168(k), which,

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<sup>244</sup> See generally STAFF OF JOINT COMM. ON TAXATION, SUMMARY OF PROVISIONS CONTAINED IN THE CONFERENCE AGREEMENT FOR H.R. 1836, THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001, at 9–12 (JCX-50-01) (May 26, 2001), available at <http://www.house.gov/jct/x-50-01.pdf>.

<sup>245</sup> John Laitner, *Inequality and Wealth Accumulation: Eliminating the Federal Gift and Estate Tax*, in RETHINKING ESTATE AND GIFT TAXATION, *supra* note 235, at 258, 281.

<sup>246</sup> U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2005 REVENUE PROPOSALS 5 (2004), available at <http://www.treas.gov/offices/tax-policy/library/bluebk04.pdf>.

as an additional stimulus to capital investment, allowed an immediate deduction of 30% of the adjusted basis of qualified property—primarily equipment used in a trade or business<sup>247</sup>—placed in service after September 10, 2001, and before September 11, 2004.<sup>248</sup>

The 2002 Act, although generally not directly addressing individual tax burdens apart from targeted relief for victims of terrorism, nevertheless had an important impact. The partial expensing for equipment purchases under § 168(k) can be expected to reduce corporate tax revenues significantly while it is in effect.<sup>249</sup> As discussed earlier, corporate taxes generally are considered to be borne by capital, which is owned very disproportionately by the highest-income cohorts.

### 3. The Jobs and Growth Tax Relief Reconciliation Act of 2003

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “2003 Act”) accelerated the effective date of the rate reductions enacted in the 2001 Act by putting the 25%, 28%, 33%, and 35% brackets previously scheduled to take effect in 2006 into effect for all years after 2002 and before 2011. The 2003 Act also temporarily increased (for taxable years beginning in 2003 and 2004) the standard deduction and the upper limit of the 15% regular income tax rate bracket for married taxpayers filing joint returns to twice the upper limit of the 15% regular income tax rate bracket for single taxpayers.<sup>250</sup> The 2003 Act also provided that an increase in the upper limit of the 10% rate bracket from \$6000 to \$7000 for single taxpayers and from \$12,000 to \$14,000 for married taxpayers filing joint returns (indexed for inflation in 2004), previously scheduled to take effect in 2008, would be temporarily effective in 2003 and 2004.<sup>251</sup> As a result, starting in 2003 there are six rate

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<sup>247</sup> Generally speaking, “qualified property” is modified accelerated cost recovery system (“MACRS”) property with a recovery period of twenty years or less, computer software (not subject to § 197), water utility property, or qualified leasehold improvement property, the “original use” of which commenced.

<sup>248</sup> The 2003 Act amended § 168(k) to increase the deduction to 50% of the adjusted basis of qualified property placed in service after May 5, 2003, and extended the deduction until December 31, 2004.

<sup>249</sup> The President’s 2005 Fiscal Year Budget proposals do not call for extending this provision. See generally U. S. DEP’T OF THE TREASURY, *supra* note 246.

<sup>250</sup> For taxable years beginning after 2004, the upper limit of the 15% rate bracket for married taxpayers filing joint returns reverts to the amount provided in I.R.C. § 1(a) & (f) prior to enactment of the 2003 legislation. The 2003 Act also increased the standard deduction for married couples filing a joint return for 2003 and 2004.

<sup>251</sup> See I.R.C. § 1(i) (West Supp. 2004). In 2005, the upper limit of the 10% rate bracket reverts to the amounts provided under the 2001 legislation (which are not adjusted for inflation).

brackets—10%, 15%, 25%, 28%, 33%, and 35%. As adjusted for inflation, the thresholds for taxable income in each rate bracket for taxable years beginning in the year 2003 are as follows.<sup>252</sup>

Income Tax Brackets, 2003						
Filing Status	10%	15%	25%	28%	33%	35%
Single	≤ \$7150	> \$7150	> \$29,050	> \$70,350	> \$146,750	> \$319,100
Head of Household	≤ \$10,200	> \$10,200	> \$38,900	> \$100,500	> \$162,700	> \$319,100
Married Filing Jointly	≤ \$14,300	> \$14,300	> \$58,100	> \$117,250	> \$178,650	> \$319,100
Married Filing Separately	≤ \$7150	> \$7150	> \$29,050	> \$58,625	> \$89,325	> \$159,550
Estates & Trusts	N/A	≤ \$1950	> \$1950	> \$4600	> \$7000	> \$9550

Acceleration of the rate cuts for the four highest brackets benefited only about 22% of taxpayers; 78% of taxpayers faced a 15% or lower tax rate.<sup>253</sup> The 2003 Act also temporarily increased the amount of the child credit to \$1000 for 2003 and 2004. Thereafter, the amount of the credit reverts to the amounts provided in the 2001 Act—to \$700 in 2005 through 2008, \$800 in 2009, and \$1000 in 2010.<sup>254</sup>

The lion's share of the targeted tax reductions in the 2003 Act, however, went to income from capital. First, the 2003 Act amended I.R.C. § 168(k) to increase the additional first-year deduction to 50% of the adjusted basis of qualified property placed in service after May 5, 2003, and extended the deduction until December 31, 2004.<sup>255</sup> The 2003 Act significantly reduced the maximum rate of tax on long-term capital gains. Generally speaking, most long-term capital gains realized by noncorporate taxpayers are now taxed at 15% if the taxpayer is otherwise in the 25% or higher marginal tax bracket, and at a 5% rate if the taxpayer is otherwise in a lower tax bracket.<sup>256</sup>

<sup>252</sup> Rev. Proc. 2003-85, § 1(a), 2003-49 I.R.B. 1184.

<sup>253</sup> See TAX POLICY CTR., URBAN INST. & BROOKINGS INST., NUMBER OF TAX UNITS BY TAX BRACKET tbl.T03-0215 (Dec. 19, 2003), available at <http://www.taxpolicycenter.org/TaxModel/undb/Content/PDF/T03-0215.pdf>.

<sup>254</sup> I.R.C. § 24(a)(2). After 2010, the amount of the credit reverts to \$500. The statute says the amount of the credit is \$1000 for "2010 or thereafter," but because the amendments made to § 24 by the 2001 tax legislation are scheduled to terminate at the end of 2010, without further legislation, the per child credit amount will revert to \$500 in 2011.

<sup>255</sup> The 2003 Act also increased the amount deductible under I.R.C. § 179 to \$100,000 for property placed in service in taxable years beginning in 2003, 2004, and 2005. In addition, for those years, the dollar-for-dollar phase-out of the amount begins when the cost of property placed in service exceeds \$400,000 (adjusted for inflation in 2004 and 2005).

<sup>256</sup> More specifically, "adjusted net capital gains" (as defined in I.R.C. § 1(h)(3)) realized by noncorporate taxpayers after May 5, 2003, and before 2009 are taxed at 15% if the taxpayer is otherwise in the 25% or higher marginal tax bracket, and at a 5% rate if the taxpayer is otherwise in the 10% or 15% marginal tax bracket (with a special 0% capital gains rate for

The most dramatic targeted tax relief in the 2003 Act was the drastic reduction of tax rates on dividends received by individuals with respect to corporate stock. Under the 2003 Act, dividends received from domestic and qualified foreign corporations after 2002 are taxed at the same preferential rates applicable to long-term capital gains—15% for individual taxpayers otherwise taxable at a rate greater than 15%, and 5% for individual taxpayers otherwise taxable at 10% or 15%.<sup>257</sup> Despite arguments by the proponents of these changes that they benefited everyone, based on claims that over half of Americans owned stock, these changes were essentially tax relief for the super-rich.

The 2003 Act did a bit more than the 2001 Act to ameliorate the impact of the AMT on the ever increasing number of middle and upper-middle class taxpayers—primarily those with incomes between \$50,000 and \$500,000—by increasing the exemption amounts for 2003 and 2004, but not thereafter, to \$58,000 for married taxpayers filing joint returns and to \$40,250 for singles. This temporary balm for the ever increasing anti-progressive impact of the AMT on middle-income taxpayers stands in stark contrast to the longer-term temporary reductions in § 1 rates and tax cuts on capital gains and dividends.<sup>258</sup> Although President Bush's 2005 Fiscal Year Budget proposes

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10% and 15% bracket taxpayers in 2008). Long-term capital gains excluded from the definition of "adjusted net capital gain" continue to be taxed at the same rates as before May 6, 2003. "Unrecaptured L.R.C. § 1250 gains" are taxed at a maximum rate of 25% if the taxpayer's normal marginal rate is 28% or higher (and at the taxpayer's normal rate if it is 25% or lower). Gains from collectibles held for more than one year generally are taxed at the taxpayer's normal marginal rate if the taxpayer is subject to a marginal rate of 28% or less and at 28% if the taxpayer normally is subject to a marginal rate of 33% or higher. Due to the mechanics of the calculations under I.R.C. § 1(h), there is a possibility that a taxpayer in a tax bracket below 28% who has a significant amount of adjusted net capital gain taxed at 5% or 15%, along with collectibles gain, might have collectibles gain taxed at 28%.

<sup>257</sup> I.R.C. § 1(h)(11) (West Supp. 2004). There is a special 0% rate for 10% and 15% bracket taxpayers in 2008. A dividend is eligible for the preferential rates under I.R.C. § 1(h)(11) only if the shareholder holds the share of stock on which the dividend is paid for more than sixty days during the 120-day period beginning sixty days before the ex-dividend date. IRC § 1(h)(11)(B)(iii). Although I.R.C. § 1(h)(11) treats dividends as "adjusted net capital gain" under § 1(h)(3), the dividend (in contrast to the stock) is not a capital asset as defined in I.R.C. § 1221, and dividends are not taken into account in the calculation of "net capital gain" under I.R.C. § 1222. Thus, while the 5% and 15% maximum rates under I.R.C. § 1(h) apply to dividends received by taxpayers who otherwise are in a higher marginal tax bracket, capital losses can not be deducted against dividend income, except to the extent allowed by I.R.C. §§ 1211 and 1212.

The amendment, I.R.C. § 1(h)(11), like all of the amendments in the 2003 legislation, sunsets after December 31, 2008, so that without further congressional action, after 2008 dividends again will be subject to the same tax rate as other ordinary income.

<sup>258</sup> For the anti-progressive nature of extending the AMT to middle-income taxpayers, see Leonard E. Burman et al., *The AMT: Projections and Problems*, 100 TAX NOTES 105, 114 (2003).



to make permanent the § 1 rate cuts and the reduced rates for capital gains and dividends, it proposes to extend the increased AMT exemption only through 2005.<sup>259</sup>

Recent analysis shows that the AMT will become the primary tax for most taxpayers who are not income millionaires.<sup>260</sup> In 2003, less than 1% of taxpayers with incomes between \$50,000 and \$75,000 faced AMT liability; slightly more than 1% of those with incomes between \$75,000 and \$100,000 also did so. For taxpayers with incomes between \$100,000 and \$200,000, 9.3% had AMT liability. AMT "participation" jumped to over 55% of those with incomes between \$200,000 and \$500,000, before dropping to 28.9% of taxpayers with incomes between \$500,000 and \$1 million, and only 19.3% of those with incomes of \$1 million or more. The picture will change dramatically by 2010, when more than 36% of taxpayers with incomes between \$50,000 and \$75,000 will face AMT liability; nearly 73% of those with incomes between \$75,000 and \$100,000 will pay AMT. For taxpayers with incomes between \$100,000 and \$200,000, 92% will have had AMT liability. AMT "participation" will jump to over 92% of those with incomes between \$200,000 and \$500,000, before dropping to 49.3% of taxpayers with incomes between \$500,000 and \$1 million, and only 24.1% of those with incomes of \$1 million or more.

The impact of the AMT on the tax cuts enacted in 2001 and 2003 (excluding the reduced rates for capital gains and dividends), projected for 2010, is shown in the following table.

Effect of the AMT on Income Tax Cuts, 2010 <sup>261</sup>		
AGI Class	Percent of Tax Filers with No Cut Due to AMT	Percent of Cut Taken Back by AMT
All	5.1	33.8
Less than \$30,000	<0.05	<0.05
\$30,000-50,000	0.7	1.2
\$50,000-75,000	4.0	15.3
\$75,000-100,000	4.8	37.2
\$100,000-200,000	24.1	65.0
\$200,000-500,000	45.1	71.8
\$500,000-1,000,000	9.3	15.9
More than \$1,000,000	8.1	8.2

<sup>259</sup> U.S. DEP'T OF THE TREASURY, *supra* note 246, at 164.

<sup>260</sup> See Burman et al., *supra* note 258, at 105.

<sup>261</sup> *Id.* at 116 tbl.6.

Thus, for many taxpayers the “permanent” tax cuts in the 2003 Act were as illusory as the tax cuts in the 2001 Act. Ironically, given that the original theory of the AMT was to impose a lower marginal rate on a broader base, many of these taxpayers facing AMT liability will be subjected to a higher marginal tax rate imposed on a lower base than under the regular tax.<sup>262</sup> As in 2001, however, those with annual incomes exceeding \$1 million remained largely unscathed by increased AMT liability, free to enjoy fully the benefits of the regular tax rate reductions,<sup>263</sup> including the new 15% preferential rate for long-term capital gains and dividends received on corporate stock, which apply for AMT purposes as well as for regular tax purposes.<sup>264</sup>

All of the key provisions in the 2003 Act were originally enacted as temporary changes (like the 2001 Act), and were scheduled to sunset on December 31, 2008. As was the case with the 2001 Act, supporters of the 2003 Act did not really intend for them to sunset, and President Bush’s 2005 Fiscal Year Budget proposal calls for making permanent almost all of the key provisions in the 2003 Act (except additional first year depreciation under I.R.C. § 168(k)).<sup>265</sup>

### C. Quantifying Tax Relief for the Rich

As explained above, the impact on progressivity of the 2001 and 2003 Acts cannot be measured simply by looking at the changes in the regular income marginal rates, and preferential rates for capital gains, in I.R.C. § 1. The various changes are too complex and interact too extensively with other provisions, primarily the AMT.

It is difficult, if not impossible, to assemble from the various official reports—primarily explanations of pending legislation prepared by the Staff of the Joint Committee on Taxation—accurate estimates of the distribution among income classes of the tax relief provided by the spate of tax legislation in the first three years of the twenty-first century.<sup>266</sup> The official distributional estimates that were

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<sup>262</sup> See *id.* at 114–15 tbl.5.

<sup>263</sup> For an analysis of effective marginal rates, taking into account the AMT, for 2003, see generally Leonard E. Burman & Mohammed Adeel Saleem, *Income Tax Statistics for Sample Families, 2003*, 102 TAX NOTES 413 (2004), available at [http://www.urban.org/UploadedPDF/1000594\\_TaxNotes\\_011904.pdf](http://www.urban.org/UploadedPDF/1000594_TaxNotes_011904.pdf).

<sup>264</sup> For application of the preferential rates to capital gains and dividends under the AMT, see I.R.C. § 55(b)(3) (West Supp. 2004).

<sup>265</sup> U.S. DEP’T OF THE TREASURY, *supra* note 246, at 5.

<sup>266</sup> The Staff of the Joint Committee on Taxation has provided some distributional analysis, but it is incomplete and does not fully take into account phase-ins. See generally STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., DISTRIBUTIONAL EFFECTS OF THE

once in vogue have been abandoned, killed by criticisms of their inaccuracies.<sup>267</sup>

Some of these criticisms are valid. Distributional tables hide significant differences between individuals in the same income class—primarily because tax liabilities are highly sensitive, even more so after the 2001 and 2003 Acts—to the form of the receipt. For example, at the higher end of the income pyramid, under current law, an investor realizing most of a \$20 million annual income in the form of capital gains and dividends faces an average tax rate of less than 15%, and if the portfolio mix includes tax-free state and municipal bonds, a rate that might be much lower. Conversely, a best-selling book author earning that same amount from royalties would face an average tax rate of nearly 35%. Moving down the income pyramid, one finds that income tax liabilities for the middle class are highly sensitive to the number of children in the household, due to the dependency exemption, child credit, and earned income credit. Nevertheless, the significance of the public policy choices inherent in any tax legislation cannot be appreciated fully without considering the distributional impact of the changes, and distributional tables based on income classes are all we have to use in our analysis.

The most reliable estimates of the distribution of tax relief provided by recent legislation have been prepared by the Tax Policy Center, jointly sponsored by the Brookings Institution and the Urban Institute.<sup>268</sup> Presenting the conclusions, let alone the data, derived from the Urban-Brookings Tax Policy Microsimulation Model is a daunting task because of the year-by-year pattern of ever shifting rules resulting from the myriad phase-ins, delayed effective dates, phase-outs, and sunsets in

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CONFERENCE AGREEMENT FOR H.R. 1836 (JCX-52-01) (Comm. Print 2001), available at <http://www.house.gov/jct/x-52-01.pdf>. According to the Joint Committee estimates, the share of total federal taxes paid by taxpayers whose AGI equaled or exceeded \$100,000 would increase by slightly less than 1% for the years 2001 through 2006, while all other income cohort's shares of taxes decreased slightly or remained stable. The pattern within other cohorts was not systematic. The Joint Committee data also show that for 2006 (the last year for which data is provided) the cohort with AGI of \$200,000 or more (the highest separately stated income cohort in the data) received the largest percentage point reduction in total effective tax rates of any income cohort, although in earlier years some of the lower-income cohorts enjoy a larger percentage point reduction in effective tax rates. The differences are attributable to differing phase-ins and phase-outs of provisions that affect differing income cohorts disproportionately.

<sup>267</sup> See generally DISTRIBUTIONAL ANALYSIS OF TAX POLICY, *supra* note 117; Michael J. Graetz, *Paint-by-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609 (1995).

<sup>268</sup> See generally TAX POLICY CTR., URBAN INST. & BROOKINGS INST., at <http://www.taxpolicycenter.org/home/> (last visited Nov. 15, 2004).

all of the recent tax legislation. One might try to describe who wins big, who wins moderately, who wins nothing, and who loses on a year-by-year basis, but the cumulative big picture effect is really all that is worth considering. Otherwise, the forest will be lost for the trees.

Initially, if either the percentage of the reduction in aggregate income taxes or the percentage change in after-tax income is the yardstick, the benefits of the 2001 Act, measured by the impact in 2002, seemingly are distributed primarily to the middle classes.

2001 Act: Distribution of Income Tax Changes by Percentiles, 2002 <sup>269</sup>				
AGI Class	Dollars (Millions)	Percent of Total	Average Tax Change (\$)	% Change in After-Tax Income
Lowest Quintile	-668	0.9	-26	0.5
2d Quintile	-7489	10.6	-283	1.8
3d Quintile	-12,385	17.6	-469	1.7
4th Quintile	-15,870	22.5	-601	1.3
Next 10%	-11,508	16.3	-871	1.2
Next 5%	-7143	10.1	-1081	1.1
Next 4%	-7491	10.6	-1418	0.9
Top 1%	-7860	11.2	-5950	0.9
All	-70,489	100.0	-534	1.2

Measured by reduction in aggregate income taxes, the fourth quintile came out on top, followed by the middle quintile, but then various cohorts within the top quintile, excepting the 91st through 95th percentiles, fared better than the second quintile. (The first quintile paid so little in income taxes before the changes that it could not receive anywhere near a matching cut in income taxes.) Measured by increases in after-tax income, the second quintile came out ahead of all others, followed closely by the third and fourth quintiles. It looks like tax relief for the middle classes, but it is not, for several reasons.

First, it is important to note that the top 1%, which received 11% of the tax cut, measured in dollars, received an extraordinarily disproportionate tax cut. That group received a larger tax cut than the 4% immediately below it, the 5% immediately below the top 5%, and two-thirds of the amount received by the bottom of the top quintile,

<sup>269</sup> TAX POLICY CTR., URBAN INST. & BROOKINGS INST., EGTRRA: DISTRIBUTION OF INCOME TAX CHANGE BY PERCENTILES, 2002 tbl.T02-0022 (Nov. 19, 2002), available at <http://taxpolicycenter.org/TaxModel/tmdb/Content/PDF/T02-0022.pdf>. These calculations include changes in marginal tax rates, the 10% bracket, the child tax credit, the child and dependent care credit, the limitation on itemized deductions, the personal exemption phase-out, the AMT, the standard deduction, 15% bracket, and earned income tax credit provisions for married couples; they exclude retirement and education provisions. *Id.*

the 81st through 90th percentiles. From a slightly different perspective, those households with an AGI of more than \$1 million dollars—the less than two-tenths of 1% of households at the very top of the income pyramid—received 5.9% of the tax relief.

More importantly, these data present a deceptive picture for two reasons. First, they do not fully take into account the varying effective dates, and second, they do not take into account the impact of the estate tax repeal. Projections of the distribution of income tax changes for 2010 reveal a much different pattern.

2001 Act: Distribution of Income Tax Changes by Percentiles, 2010 <sup>270</sup>				
AGI Class	Dollars (Millions)	Percent of Total	Average Tax Change (\$)	% Change in After-Tax Income
Lowest Quintile	-982	0.6	-35	0.5
Second Quintile	-13,884	8.4	-472	2.4
Middle Quintile	-23,018	13.9	-782	2.3
Fourth Quintile	-32,965	19.9	-1120	1.8
Next 10%	-22,955	13.9	-1551	1.6
Next 5%	-8917	5.4	-1227	0.9
Next 4%	-6242	3.8	-1061	0.5
Top 1%	-56,570	34.1	-38,473	4.5
All	-165,672	100.0	-1126	2.0

By 2010 the clear winner has emerged, and it is the top 1% by such a wide margin that it is hardly worth discussing the differences between the other income cohorts,<sup>271</sup> or how far below the top 1% they are as a relative matter in the congressional largesse sweepstakes. The top 1%, a group that collectively realizes just under 20% of the total income, walked away with 34% of the income tax relief in the 2001 Act, at least

<sup>270</sup> *Id.* These calculations include changes in marginal tax rates, the 10% bracket, the child tax credit, the child and dependent care credit, the limitation on itemized deductions, the personal exemption phase-out, the AMT, the standard deduction, 15% bracket, and earned income tax credit provisions for married couples; they exclude retirement and education provisions. *Id.*

<sup>271</sup> A point worth making is that the greater benefits for the second and third quintiles, relative to everyone else apart from the top 1%, mostly arise not from the rate cuts but from expansion of the child credit and widening of the 15% bracket for married couples. Childless married couples and singles in these income cohorts do not receive anywhere near the benefits that married couples with children receive, their primary benefit being the new 10% rate bracket. The average tax cut for singles with children was \$1114, for single parents, \$326, and for singles, only \$283. See GRAVELLE, *supra* note 116, at 12–13. For further illustrations, see generally Carasso, *supra* note 217.

as measured by the year 2010, which is far more representative than the year 2002.<sup>272</sup>

The 2001 Act provided such a number of interrelated changes that, short of a computer simulation, it is difficult to describe how specific provisions deliver or fail to deliver benefits to the various income classes. The new 10% bracket helped all taxpayers who previously had a positive tax liability *after credits*, but did nothing for the tens of millions of filers with no liability; the increased child credit helped middle-income taxpayers with children—the more children, the more help (unless the AMT clawed back the benefits of the regular tax rate reductions). The increase in the ceiling on the 15% bracket helped primarily upper-middle class taxpayers, but the other rate cuts disproportionately helped taxpayers toward the top of the income pyramid—the closer to the top, the more the help. But the income tax changes are far from the entire story of the 2001 Act.

When the effect of the repeal of the estate tax, which all of the proponents of its demise expect to be permanent, not temporary, is factored in, the congressional solicitude for the super-rich is even more striking.

<sup>272</sup> The Tax Policy Center projections for making the 2001 Act permanent (made before the 2003 Act was enacted) show slightly different values, with only 39% of the benefits inuring to the top 1%, but the same general picture is painted.

2001 Act Made Permanent: Distribution of Income Tax Changes by Percentiles, 2012				
AGI Class	Dollars (Millions)	Percent of Total	Average Tax Change (\$)	% Change in After-Tax Income
Lowest Quintile	-1072	0.6	-37	0.5
Second Quintile	-14,940	8.9	-494	2.4
Middle Quintile	-24,335	14.5	-804	2.2
Fourth Quintile	-32,886	19.6	-1087	1.7
Next 10 Percent	-19,244	11.5	-1272	1.2
Next 5%	-5816	3.5	-769	0.5
Next 4%	-5686	3.4	-940	0.4
Top 1%	-63,537	37.9	-42,003	4.5
All	-167,663	100.0	-1108	1.8

Source: TAX POLICY CTR., URBAN INST. & BROOKINGS INST., EGTRRA: DISTRIBUTION OF INCOME TAX CHANGE BY PERCENTILES, 2002 tbl.T02-0022 (Nov. 19, 2002), available at <http://taxpolicycenter.org/TaxModel/tmdb/Content/PDF/T02-0022.pdf>.

2001 Act: Distribution of Income Tax Changes and Estate Tax Repeal, by Percentiles, 2010 <sup>273</sup>				
AGI Class	Dollars (Millions)	Percent of Total	Average Tax Changes (Dollars)	Percent Change in After-Tax Income
Lowest Quintile	-982	0.4	-35	0.5
Second Quintile	-13,884	6.2	-472	2.4
Middle Quintile	-23,018	10.3	-782	2.3
Fourth Quintile	-33,436	14.9	-1136	1.9
Next 10%	-24,721	11.0	-1668	1.7
Next 5%	-11,979	5.3	-1632	1.2
Next 4%	-22,020	9.8	-3669	1.9
Top 1%	-94,367	42.0	-63,460	7.7
All	-224,546	100.0	-1,515	2.7

Taking into account the estate tax repeal, the top 1%—roughly 1.1 million households in the United States—walked away from the 2001 Act with 42% of the goodies.<sup>274</sup> And this is without the benefit of the further tax cuts inuring disproportionately to the super-rich in the 2003 Act.

The major changes in the 2003 Act that further skew the benefit of the recent tax cuts in favor of the super-rich are the reduction of the tax rates on capital gains and dividends. Capital gains and dividends are a much larger share of the income of people who have high incomes than of people whose incomes are lower.<sup>275</sup> The Tax Policy

<sup>273</sup> TAX POLICY CTR., URBAN INST. & BROOKINGS INST., EGTRRA: DISTRIBUTION OF INCOME TAX CHANGES AND ESTATE TAX REPEAL BY PERCENTILES, 2010, at tbl.T03-0215 (Nov. 19, 2002), available at <http://www.taxpolicycenter.org/TaxModel/tmdb/Content/PDF/T02-0025.pdf>.

<sup>274</sup> The Tax Policy Center projections for making the 2001 Act permanent made before the 2003 Act was enacted, show slightly different values, with 42% of the benefits inuring to the top 1%, but the same general picture is painted.

<sup>275</sup> See ESENWEIN & GRAVELLE, *supra* note 114, at 7–8 (indicating that for 1999, the top 2% earned 73% of capital gains and the top 7.5% earned 85%); Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, 89 FED. RESERVE BULL. 1, 16 (2003) (indicating that direct ownership of corporate stock and mutual funds (outside of pension plans) is highly concentrated in high-income and high-wealth families), available at <http://www.federalreserve.gov/pubs/bulletin/2003/0103lead.pdf>; Burman & Kodes, *supra* note 114, at 783 (indicating that preliminary data for 2001 show that capital gains made up 21% of income for those with AGI above \$200,000 (the highest cohort broken out), compared with 27% in 2000, and further indicating that capital gains were 71% of the income reported by the 400 highest-income taxpayers in 2000, while wages were less than 17%); Burman & Ricoy, *supra* note 114, at 428 (indicating that taxpayers with average income over \$200,000 between 1979 and 1988 earned 38% of that income in the form of capital gains, and that for the population as a whole, capital gains constituted only 6% of income); Jane G. Gravelle, *Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences*, 56 NAT'L

Center's distribution tables for the 2003 Act, comparable to those it prepared for the 2001 Act, demonstrate that the top 1% continues to claim the lion's share of the tax cuts. For 2005, 64% of the benefits of the 2003 Act will go to the top 1% of taxpayers. That group will see a 3.0% increase in its after-tax income solely as a result of tax cuts. The bottom 90% of taxpayers will receive only 16.9% of the tax cut and the bottom 80% only 7.6% of the tax cut.

More importantly, the effect on after-tax income, which is the best measure of distributional neutrality of a tax cut,<sup>276</sup> was skewed to favor the very top of the income pyramid. The top 1% will see a 3% increase in after-tax income as a result of the tax cut, whereas no other income cohort will see more than a 0.6% increase in after-tax income, and no income cohort outside the top 10% will see more than a 0.3% increase in after-tax income.

2003 Act, Distribution of Income Tax Changes by Percentiles, 2005 <sup>277</sup>			
AGI Class	Percent of Total	Average Tax Change (\$)	Percent Change in After-Tax Income
Lowest Quintile	<0.05	<\$1	<0.05
Second Quintile	0.3	-5	<0.05
Middle Quintile	1.4	-21	0.1
Fourth Quintile	5.9	-89	0.2
Next 10%	7.9	-236	0.3
Next 5%	8.2	-491	0.5
Next 4%	12.3	-920	0.6
Top 1%	64.0	-19,226	3.0
All	100.0	-300	0.7

The Tax Policy Center analysis further shows that an astounding 17.3% of the tax relief in the 2003 Act went to approximately 184,000 taxpayers with AGI of more than \$1 million—less than 0.1% of all taxpayers. Another 6.3% went to 359,000 taxpayers with AGI of between \$500,000 and \$1 million. These data clearly demonstrate that the 2003 Act was highly skewed in favor of the super-rich. Given that the legislation was passed against the backdrop of massive federal

Tax J. 653, 654 (2003) (indicating that 40% of taxable dividends are received by the top 2%).

<sup>276</sup> Gale & Potter, *supra* note 220, at 3.

<sup>277</sup> TAX POLICY CTR., URBAN INST. & BROOKINGS INST., CONFERENCE AGREEMENT ON THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003: DISTRIBUTION OF INCOME TAX CHANGE BY PERCENTILES, 2005, at tbl.T03-0112 (May 22, 2003), available at <http://taxpolicycenter.org/TaxModel/tmdb/Content/PDF/T03-0112.pdf>.



deficits and was projected significantly to increase those deficits,<sup>278</sup> this is truly welfare for the wealthy.

Rudolph Penner has summarized the combined effects of the 2001 through 2003 tax cuts as follows:

For the bottom 40 percent of the distribution, the individual income tax has become negative on average; that is, refundable tax credits exceed the liability stemming from positive tax rates. The effects of 2001–03 legislation were minor for this group as a whole. For the next 59 percent of the distribution, it is difficult to discern a pattern. Increases in after-tax income resulting from the cuts are similar in various percentiles, ranging from 2.3 to 3.6 percent for the classifications shown in the table. The proportionate cut in tax rates is, however, considerably larger at the bottom than at the top of this 59 percent.

The top 1 percent appears to reap a bonanza. Their after-tax income rises 6.0 percent and the fall in the income tax rate is larger than for any other group in the top quintile. The large tax cut at the top is a result of two factors. The first is ironic. The alternative minimum tax (AMT), originally designed to limit how much the rich could lower their tax bill with various deductions and exclusions, has become largely irrelevant for the ultra-rich because the top income tax rate exceeds the AMT rate. Consequently, those at the very top of the income distribution enjoy the full benefit of the 2001–03 tax cut, whereas most of those

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<sup>278</sup> See generally CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE* (2003), available at <http://www.cbo.gov/ftpdocs/44xx/doc4493/08-26-Report.pdf> (last modified Aug. 25, 2003); ISAAC SHAPIRO & NICHOLAS JOHNSON, CTR. ON BUDGET & POLICY PRIORITIES, *TOTAL REVENUES FROM ALL LEVELS OF GOVERNMENT DROP TO LOWEST SHARE OF ECONOMY SINCE 1968* (Jan. 15, 2004), available at <http://www.cbpp.org/1-15-04bud.pdf>. A projection by the Center on Budget and Policy Priorities, the Committee for Economic Development, and the Concord Coalition that is based on the CBO data and economic assumptions, but with adjustments for more plausible assumptions regarding federal tax and spending policy, shows deficits totaling \$5 trillion over the period from 2004 through 2013. Under this projection, deficits never fall below \$420 billion, reach \$610 billion—or 3.4% of Gross Domestic Product (“GDP”)—by 2013, boost the publicly held debt to 51% of GDP by 2013, and cause federal interest payments to hit \$470 billion, or 15% of revenues, in that year. See generally CTR. ON BUDGET & POLICY PRIORITIES ET AL., *MID-TERM AND LONG-TERM DEFICIT PROJECTIONS* (Sept. 29, 2003), available at [http://www.concordcoalition.org/federal\\_budget/030929report.pdf](http://www.concordcoalition.org/federal_budget/030929report.pdf).

somewhat farther down the distribution have a portion of their benefits taken away by the AMT.<sup>279</sup>

This lopsided distribution of tax cut benefits is easily understood if one examines the distribution of ownership of capital assets and corporate stock, both of which are highly concentrated. Although it might be true that ownership of capital and capital income is not as highly concentrated as it was in the later part of the nineteenth century and the first few decades of the twentieth century,<sup>280</sup> capital wealth in general remains highly concentrated.

In 1998 the richest 1% of households held half of all outstanding stock, financial securities, and trust equity, two-thirds of business equity, and 36% of investment real estate. The top 10% of families as a group accounted for about 90% of stock shares, bonds, trusts, and business equity, and about three-quarters of non-home real estate. Moreover, despite the fact that 48% of households owned stock shares either directly or indirectly through mutual funds, trusts, or various pension accounts, the richest 10% of households accounted for 79% of the total value of these stocks, only slightly less than its 85% share of directly owned stocks and mutual funds.<sup>281</sup>

Personal ownership of corporate stock—the source of dividends—is highly concentrated. The top 1% holds as much as 53% of household stock holdings.<sup>282</sup> The top 2% receive approximately 40% of all taxable dividends.<sup>283</sup> Furthermore, over one-half of all realized capital gains are realized with respect to stock.<sup>284</sup> With this kind of concentration of wealth, particularly corporate stock, is it any wonder that a tax cut targeted at dividends and capital gains is extraordinarily lopsided in favor of the wealthy? It could not be otherwise.

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<sup>279</sup> RUDOLPH G. PENNER, *SEARCHING FOR A JUST TAX SYSTEM* 15 (Urban-Brookings Tax Policy Ctr., Discussion Paper No. 13, 2004), available at [http://www.taxpolicycenter.org/UploadedPDF/410907\\_TPC\\_DP13.pdf](http://www.taxpolicycenter.org/UploadedPDF/410907_TPC_DP13.pdf).

<sup>280</sup> See Piketty & Saez, *supra* note 42, at 19.

<sup>281</sup> WOLFF, *supra* note 87, at 4; see Ana M. Aizcorbe et al., *supra* note 275, at 10–11 (indicating that direct ownership of corporate stock and mutual funds (outside of pension plans) is highly concentrated in high-income and high-wealth families).

<sup>282</sup> ANNAMARIA LUSARDI ET AL., *SAVINGS PUZZLES AND SAVINGS POLICIES IN THE UNITED STATES* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 8237, 2001).

<sup>283</sup> Gravelle, *supra* note 114, at 654.

<sup>284</sup> G. Thomas Woodward, *Capital Gains Taxes and Federal Revenues*, REVENUE & TAX POLICY BRIEF (Cong. Budget Office, Wash., D.C.), Oct. 9, 2002, at 2 fig.1, available at <http://www.cbo.gov/ftpdocs/38xx/doc3856/TaxBrief2.pdf>.

Most capital gains are reported by wealthy investors who hold many assets and sell assets frequently.<sup>285</sup> The data indicate that a high percentage of taxpayers who realize capital gains do so regularly.<sup>286</sup> In 2000, capital gains were 71% of the income of the 400 highest-income taxpayers. For 2000, capital gains were 27% of income for those with AGI above \$200,000 (the highest cohort broken out by the IRS), but in 2001, due to a depressed stock market, capital gains fell to 21% of the group's income.<sup>287</sup> The most recent study of long-term averages (covering the period from 1979 through 1988) shows that the top 1% realized 57% of capital gains and the top 3% realized 73% of capital gains; from that data it can be estimated that the top 2% realized about two-thirds of all capital gains.<sup>288</sup> In 1999, however, the top 2% realized 73% of all capital gains and the top 7.5% realized 85% of all capital gains.<sup>289</sup> For that year, taxpayers with AGIs of \$1 million or more realized 47% of all long-term capital gains, and taxpayers with AGIs of \$500,000 or more realized 56% of all capital gains.<sup>290</sup>

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<sup>285</sup> Burman & Ricoy, *supra* note 114, at 443–44. Leonard E. Burman & Peter D. Ricoy stated the following:

In 1993, 38 percent of returns with capital gains reported only one transaction . . . . About 57 percent of returns with gains reported two or fewer. But these returns had much smaller than average gains, and so they contributed relatively little to overall capital gains. Returns with a single transaction accounted for only eight percent of gains. Returns with one or two transactions accounted for 15 percent of the total. The 19 percent of returns with gains that reported more than five transactions, however, accounted for 59 percent of all capital gains.

*Id.*

<sup>286</sup> For analysis of capital gains realizations over time, indicating that individuals realizing capital gains generally are not in the highest-income group by reason of one-shot or occasional recognition of capital gain, but that they tend to realize capital gains regularly, see Burman & Ricoy, *supra* note 114, at 440–43; Albert J. Davis, *Measuring the Distributional Effects of Tax Changes for the Congress*, 44 NAT'L TAX J. 257, 259–60 (1991). Nevertheless, Joel Slemrod concludes that because capital gains realizations are more responsive to changes in the marginal rate than other forms of income, including such gains in ranking incomes can lead to rank reversals. Joel Slemrod, *On the High-Income Laffer Curve*, in TAX PROGRESSIVITY AND INCOME INEQUALITY, *supra* note 112, at 177, 203–09.

<sup>287</sup> Burman & Kodes, *supra* note 114, at 783.

<sup>288</sup> ESENWEIN & GRAVELLE, *supra* note 114, at 8.

<sup>289</sup> *Id.* at 7–8; see Burman & Ricoy, *supra* note 114, at 428. For details regarding the realization of capital gains in 1999 broken down by income class, see generally Janette Wilson, Internal Revenue Serv., *Sales of Capital Assets Reported on Individual Income Tax Returns, 1999*, 23 STATISTICS OF INCOME BULL. 132 (Summer 2003), available at <http://www.irs.gov/pub/irs-soi/99soca.pdf>.

<sup>290</sup> Wilson, *supra* note 289, at 140 tbl.2a. Percentage calculations made by author using data in table.

The case of the Fortunate 400 is striking. In 2000, the Fortunate 400 had 8.13% of total net capital gains. Even before the Bush tax cuts, when dividends were taxed at ordinary income tax rates and capital gains were taxed at 20%, the average income tax rate of the Fortunate 400—a group that in 2000 could be joined only by those that had greater than \$87 million of AGI—was 22.3%.<sup>291</sup> That was lower than the rate on those with only \$1 million of income, whose peak average income tax rate was 29.4%.<sup>292</sup> Because membership in the Fortunate 400 depends largely on capital gains realizations, the regressive rate structure is a product of the lower rate on capital gains.

To be sure, there is some argument that the extraordinarily high incomes of the Fortunate 400 reflect the lumpiness of capital gains realizations, but that does not substantially affect the regressive rate issue. If long-term capital gains were taxed at the same rate as ordinary income, but were allowed forty-year income averaging, over \$50 million of the capital gains of the lowest-income member of the Fortunate 400 would nevertheless have been taxed at the highest marginal rate (assuming current rate schedules were applied to all years). This is a good illustration of the effect of the rate preference because the realization requirement largely cancels out the failure to index basis for inflation over such a period.<sup>293</sup>

Even a 22.3% tax rate on the Fortunate 400 might overstate the actual tax rate. Assume that the Fortunate 400 and the *Forbes* 400 (the wealthiest individuals) were congruent—a counter-factual assumption. Taking into account the change in wealth of the *Forbes* 400, their effective tax rate on economic income, which includes unrealized appreciation, was only 9%.<sup>294</sup> As a result of the 2003 Act, the Fortunate 400 will do even better, because the capital gains tax rate has been reduced by 25%, from 20% to 15%. If an effective income tax rate of 9% is reduced by 25%, the resulting 6.5% income tax rate, plus the effective corporate tax burden allocable to the group probably is roughly comparable to the overall effective tax rate on the second income quintile.

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<sup>291</sup> See generally Sullivan, *supra* note 38.

<sup>292</sup> See generally *id.*

<sup>293</sup> See Daniel Halperin & Eugene Steuerle, *Indexing the Tax System for Inflation*, in *UNEASY COMPROMISE, PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX SYSTEM* 347, 353–56 (Henry J. Aaron et al. eds., 1988). See generally Calvin H. Johnson, *The Undertaxation of Capital Gains*, 55 *TAX NOTES* 807 (1992).

<sup>294</sup> See generally Sullivan, *supra* note 38.

When all is said and done, the combined effects of the tax cuts enacted in the 2001 through 2003 period are startling, even without considering the effects of the estate tax reduction and repeal. In 2003, before the full effects of the tax cuts targeted to the super-rich were fully effective, the after-tax income of households with incomes that exceed \$1 million was increased by nearly \$112,925 per household—a 5.4% average increase in after-tax income. For the top 1% of households, the average after-tax income increase was \$26,335 per household, or 4.6%. After-tax income of households in the middle quintile increased by \$676, or 2.6%. Thus, in percentage terms, the income tax cuts alone increased the after-tax incomes of income millionaires by twice as much as they increased the after-tax incomes of those in the middle of the income scale, and by twenty-seven times the increase for those at the bottom fifth of the income pyramid. The dollar values of the skewed benefits are far greater.<sup>295</sup>

The President's 2005 Fiscal Year Budget proposes that the various sunsets on the tax cuts enacted in 2001 through 2003 be removed and that the tax cuts be made permanent.<sup>296</sup> This proposal, if adopted will further increase the regressivity of the twenty-first century tax cuts. The Tax Policy Center has preliminarily described the effect of making the tax cuts permanent as follows:

The expiring tax cuts are regressive—they provide a larger percentage cut in after-tax income for high-income households than for low-income households. If the tax cuts were made permanent, filers with income above \$1 million would see a 5.7 percent increase in their after-tax income, whereas filers with income below \$50,000 would see just a 2.2 percent average increase in their after-tax income. (These figures do not include the estate tax repeal, which is also quite regressive.)

The percentage changes in after-tax income are the most theoretically preferred method of examining the progressivity of tax changes, but attention also naturally focuses on other measures. For example, the top 1 percent would receive 27 percent of the tax cuts provided by making the expiring provisions permanent, even though that group pays only 21 percent of federal taxes. As a second example, taxpayers with income above \$1 million would receive average

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<sup>295</sup> GREENSTEIN & SHAPIRO, *supra* note 27.

<sup>296</sup> U.S. DEP'T OF THE TREASURY, *supra* note 246, at 5.

annual tax cuts of \$107,000 (again, this does not include the estate tax). This is higher than the income of about 86 percent of tax filing units.<sup>297</sup>

A study published by the Center on Budget and Policy Priorities estimated that if making estate tax repeal permanent is factored in, when the tax cuts are fully phased in, the top 1% would see a 7.3% change in their after-tax income, while the middle income quintile would see only a 2.5% increase in after-tax income.<sup>298</sup> Another study, by the Tax Policy Center estimated that if the tax cuts are made permanent, the top 1% would receive a 9.2% increase in after-tax income, the middle 60% of the income distribution would receive between a 2.0% and 2.7% increase in after-tax income, and the bottom quintile would receive an increase of only 0.1% of income.<sup>299</sup> In calling for the tax cuts to be made permanent, however, President Bush did not mention how the benefits would be distributed. Instead, he referred to those small benefits that inured to lower income taxpayers.<sup>300</sup>

The President Bush's 2005 Fiscal Year Budget provides further tax relief for the wealthy.<sup>301</sup> Under the proposal, the three types of individual retirement accounts ("IRA") under current law would be consolidated into a single "retirement savings account" ("RSA"). Individuals could contribute up to \$5000 (or earnings, if less) to an RSA annually. As in the case of current Roth IRAs, and unlike regular IRAs, contributions would be nondeductible but earnings and retirement withdrawals would be tax-exempt. All income limits on eligibility would be removed. Thus, many individuals who cannot make contributions to Roth IRAs under current law, because they are covered by a qualified employer plan, could make contributions to an RSA. In addition, individuals could contribute up to \$5000 annually, whether or not they had earn-

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<sup>297</sup> WILLIAM G. GALE ET AL., BROOKINGS INST., KEY POINTS ON MAKING THE BUSH TAX CUTS PERMANENT, at <http://www.brookings.edu/views/op-ed/gale/20040121taxcuts.htm> (Jan. 21, 2004).

<sup>298</sup> JOEL FRIEDMAN & ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, THE PRESIDENT'S PROPOSAL TO MAKE TAX CUTS PERMANENT \$2.5 TRILLION COST POSES DANGER TO ECONOMY IN THE LONG RUN (Jan. 30, 2004), available at <http://www.cbpp.org/1-22-04tax.pdf>.

<sup>299</sup> William G. Gale & Peter R. Orszag, *Should the President's Tax Cuts Be Made Permanent?*, 102 TAX NOTES 1277, 1286-87 (2004).

<sup>300</sup> President George W. Bush, State of the Union Address (Jan. 20, 2004), <http://www.whitehouse.gov/news/releases/2004/01/20040120-7.html> (last visited Nov. 15, 2004). Furthermore, the 2005 Fiscal Year Budget proposals provide only minimal AMT relief. U.S. DEP'T OF THE TREASURY, *supra* note 246, at 163-64. See generally Burman et al., *supra* note 214.

<sup>301</sup> See U.S. DEP'T OF THE TREASURY, *supra* note 246, at 10-11.

ings, to a "lifetime savings account" (the "LSA"), regardless of wage income. LSAs are an entirely new tax-favored savings vehicle. As with RSAs, contributions would be nondeductible and earnings would accumulate tax-free, but in the case of LSAs, *all* distributions would be excluded from gross income, regardless of the individual's age or use of the distribution. Again, there would be no income limits on eligibility to make LSA contributions.

Despite rhetoric to the contrary, these proposals are targeted at the rich. A family of four—spouses and two children—could put \$20,000 per year in LSAs,<sup>302</sup> and an additional \$10,000 in RSAs (assuming only the spouses have wages), wholly apart from their participation in employer-provided retirement plans. The Treasury Department has estimated that this proposal would *raise* revenues by \$21 billion for the five-year period 2005 to 2009, but only by approximately \$5.6 billion for 2005 to 2014.<sup>303</sup> These projections presumably are based on individuals shifting from making contributions to deductible tax-preferred savings plans—IRAs—under current law, which would no longer be available, to nondeductible LSAs and RSAs, and taxes imposed as individuals elected to roll over balances in old deductible-at-deposit/taxable-at-withdrawal accounts to the new accounts, which would trigger a current tax. Some analysts question whether the short-term revenue increases are realistic.<sup>304</sup>

More importantly, these proposals would effect a major change in the fundamental nature of our tax system. Over time, as the balances in these accounts increase, investment income from capital—interest, dividends, and capital gains—would be eliminated from the tax base for all but the very rich. According to a study by the Tax Policy Center, if everyone who is eligible takes advantage of LSAs, the revenue *losses* could be \$100 to \$200 billion over the first ten years and could continue to grow over time. Most of the benefits of the tax cuts represented by this revenue loss would go to high-income households.<sup>305</sup> Participation in retirement accounts and the amount held in

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<sup>302</sup> The limitation is on the amount that may be contributed to one person's LSA, not on the contributions by one individual to LSAs for that person and others. Thus, one spouse could transfer \$5000 to each of four LSAs.

<sup>303</sup> U.S. DEP'T OF THE TREASURY, *supra* note 246, at 12.

<sup>304</sup> See generally Leonard E. Burman et al., *Key Thoughts on RSAs and LSAs* (Feb. 4, 2004), available at <http://www.urban.org/UploadedPDF/1000600.pdf>.

<sup>305</sup> See generally Leonard E. Burman et al., *The Administration's Savings Proposals: Preliminary Analysis*, 98 TAX NOTES 1423 (2003) (analyzing similar proposals in the 2004 budget); Leonard E. Burman et al., *supra* note 304.

retirement accounts increases significantly as income increases.<sup>306</sup> Furthermore, these households can be expected to respond mostly by shifting existing assets into LSAs rather than by undertaking new saving.<sup>307</sup> This has most likely been the experience with IRAs.<sup>308</sup> Thus, the proposal is unlikely to have much of an effect on private savings.<sup>309</sup> Even the CBO agrees with this assessment.<sup>310</sup> Because, as will be discussed in Part VI, the savings rate does not respond positively to lower taxes on the yield to capital, it is merely a tax cut for those who are already savers. Indeed, the CBO estimates that the complete package of the President Bush's 2005 Fiscal Year Budget proposals will reduce the effective tax rate on capital income to 13.3%, which would be an 8.7% reduction in the effective rate that otherwise would be in effect after 2010.<sup>311</sup>

#### D. The End Game

The inevitable effect of the cumulative tax cuts in the 2001, 2002, and 2003 Acts, and those proposed for 2005, if enacted, will be to increase further the concentration of after-tax income and wealth at the top of the pyramid. The highest-income cohorts have benefited from

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<sup>306</sup> See Aizcorbe et al., *supra* note 90, at 11–13. Within the top income decile, over 150% more households participate in retirement accounts than within the next lower income decile, and the median value of holdings of the top decile is more than 250% of the value of the holding of the next lower decile. Fewer than 20% of the households in the first three income quintiles participate in retirement plans, and the median holdings of participants is less than 20% of the holdings of the top decile. *Id.* at 13 tbl.5.B.

<sup>307</sup> See Burman et al., *supra* note 305, at 1423–24.

<sup>308</sup> See SLEMRD & BAKIJA, *supra* note 174, at 242–44 (noting that most saving is done by people who save more than the maximum amount that can be put in an IRA). See generally JANE G. GRAVELLE, CONG. RESEARCH SERV., LIBRARY OF CONG., INDIVIDUAL RETIREMENT ACCOUNTS (IRAs) AND RELATED PROPOSALS, reprinted in 95 TAX NOTES TODAY (Mar. 24, 1995), LEXIS, 95 TNT 61-25 (indicating that IRAs do not have a significant effect on savings; IRA contributions have been largely the shifting of savings that would have occurred in any event); Jane G. Gravelle, *Do Individual Retirement Accounts Increase Savings?*, 5 J. ECON. PERSP., Spring 1991, at 133. But see generally R. Glenn Hubbard, *Do IRAs and Keoghs Increase Saving?*, 37 NAT'L TAX J. 43 (1984) (concluding that evidence indicates that IRAs increase net savings).

<sup>309</sup> See generally Burman et al., *supra* note 305 (analyzing similar proposals in the 2004 budget); Burman et al., *supra* note 304.

<sup>310</sup> CONG. BUDGET OFFICE, AN ANALYSIS OF THE PRESIDENT'S BUDGET PROPOSAL FOR 2005, at 41 (2004) (stating that "CBO estimates that the new savings accounts that the President has proposed would have little effect on the economy, on average, through 2014. Most taxpayers would simply save the same amount in one of the new accounts as they would have saved in one of their present tax-free accounts."), available at <http://www.cbo.gov/ftpdocs/51xx/doc5151/03-08-PresidentsBudget.pdf>.

<sup>311</sup> *Id.* at 31.



tax cuts that are greater than the average tax cut by any measure.<sup>312</sup> Most importantly, the percentage by which after-tax income has increased as a result of the tax cuts is higher for the top 1% than for any other income cohort, and higher for income millionaires than for the remainder of the top 1%. Even if the tax cuts had increased the after-tax incomes of all income cohorts by an identical across-the-board percentage, income inequality would have increased.

Income inequality is further increased by the reduction in corporate income taxes. The burden of corporate income taxes is borne disproportionately by high-income individuals. There is a strong correlation between income and wealth, a strong correlation between wealth and income from capital, and the corporate tax is borne by all income from capital. The ownership of income producing capital is highly concentrated in the top 1% and in smaller even more elite cohorts within that small group. When corporate taxes are reduced, whether through direct congressional action, or through corporate self help—tax shelters, expatriation through corporate inversions, or even excessive tax-free perquisites for corporate executives (which nevertheless remain deductible to the corporation)<sup>313</sup>—the effective tax rate on the super-rich, as the owners of an extraordinarily disproportionate share of corporate stock, is reduced disproportionately to other taxpayers.

Income inequality will be further increased by the impact of increasing payroll taxes, the ceiling on the Social Security portion of which increases annually. The average payroll tax rate rises more rapidly for those taxpayers whose income is just above the ceiling for the previous year than it does for taxpayers whose income is relatively further above the previous ceiling because a greater portion of the previously untaxed wage income is now subject to tax. Furthermore, as total incomes move up the income pyramid, wages generally represent a smaller percentage of total income. Thus, identical increases in the absolute amount of payroll taxes represent a greater increase in

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<sup>312</sup> In August 2004, the CBO published an analysis of projected effective tax rates for the years 2001 through 2014 that confirms these conclusions. See generally CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES UNDER CURRENT LAW, 2001–2014 (Aug. 2004), available at <http://www.cbo.gov/ftpdocs/57xx/doc5746/08-13-EffectiveFedTaxRates.pdf> (last visited Nov. 15, 2004). The CBO Report concludes that for every year in that period, the top 1% receives a greater percentage decrease than any other income cohort in (1) effective individual income tax rates, (2) total effective federal tax rates, and (3) share of total federal taxes paid. The CBO data shows that the fourth quintile, and for many years, the 91st to 99th percentiles, bear an increase in the share of total federal taxes paid. See generally *id.*

<sup>313</sup> See FRIEDMAN, *supra* note 176, at 9–11.

average tax rates for those with relatively less income. This change in average tax rates increases after-tax income inequality.

Decreased progressivity in the income tax will increase not only income inequality, but wealth inequality as well.<sup>314</sup> “[P]rogressive taxation has cumulative dynamic effects because it reduces the net return on wealth, which generates tomorrow’s wealth.”<sup>315</sup> It is obvious that the repeal of the estate tax will further increase wealth disparities. The core purpose of the estate tax is to break up great fortunes and to be antidynastic.<sup>316</sup> But the repeal of the estate tax will even further increase income inequality. Without an estate tax, the heirs to great fortunes will have an even greater amount of capital on which they will earn before-tax income than they would have had if there had been an estate tax. This increased before-tax income will *per force* increase after-tax income, which in turn will further increase wealth inequality, and the cycle will continue like the magic of compound interest.

It is unlikely that the end result is something that most Americans would support on either moral or economic grounds. The United States already has very high income inequality compared with other industrialized nations. By the mid-1980s the inequality was higher than in any major Western European industrialized democracy,<sup>317</sup> and it continues to be so.<sup>318</sup> According to the United Nations Human Development Report for 2003, greater economic inequality generally is found only in South America, a number of African countries, and a few Southeast Asian countries.<sup>319</sup> The United States is moving backwards. “The decline in income tax progressivity since the 1970s and the . . . repeal of the estate tax might again produce in a few decades levels of wealth concentration similar to those at the beginning of the [twentieth] century.”<sup>320</sup> The rich will get richer, and they will get richer relative to everyone else. And nothing assures that everyone else will be better off. Indeed, there is good reason to believe that everyone else might be worse off as a result.

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<sup>314</sup> KOPCZUK & SAEZ, *supra* note 102, at 31.

<sup>315</sup> Piketty & Saez, *supra* note 42, at 23.

<sup>316</sup> Franklin D. Roosevelt, Message to Congress (June 19, 1935), in H.R. REP. NO. 74-1681, at 2 (1935), *reprinted in* 1939-1 C.B. (pt. 2) 642, 643; Steuerle, *supra* note 235, at 109.

<sup>317</sup> See LAWRENCE MISHEL & JARED BERNSTEIN, *THE STATE OF WORKING AMERICA*, 1994-95, at 340-51, 342 tbl.8.8 (1994).

<sup>318</sup> See U.N. DEV. PROGRAMME, *Inequality in Income or Consumption*, in U.N. HUMAN DEV. REPORT 2003, at 282-85 tbl.13, available at [http://www.undp.org/hdr2003/indicator/pdf/hdr03\\_table\\_13.pdf](http://www.undp.org/hdr2003/indicator/pdf/hdr03_table_13.pdf) (last modified June 20, 2003).

<sup>319</sup> See *id.*

<sup>320</sup> Piketty & Saez, *supra* note 42, at 24.

## V. THE ECONOMIC ARGUMENTS

Traditional tax policy analysis focuses on (1) whether the tax system raises adequate revenue, (2) in an equitable manner, (3) without undue complexity, and (4) without undue interference with the economic system.<sup>321</sup> Many economists focus on avoiding interference with the efficiency of the market economy.<sup>322</sup> An efficient market economy, however, is not an end unto itself, but rather it is "merely a means to the encouragement of production and the generation of wealth."<sup>323</sup> "[T]he rationale behind a market-based system is that we achieve . . . profits and wages by making others better off. The exchanges are meant to make society richer as a whole."<sup>324</sup> In other words, distribution counts.<sup>325</sup> To the extent that those lower on the income pyramid are not benefited as a result of increased economic efficiency resulting from disproportionate tax cuts for those at the top of the income pyramid, avoidance of interference with the market diminishes greatly in importance, and the other criteria become relatively more important. This is particularly true if the tax cuts result in diminished government spending on programs that benefit the population broadly. In that case, the tax cuts and spending cuts together represent a public policy decision to reduce the after-tax income of those lower on the income pyramid who received disproportionately small tax cuts and increase the after-tax income of those at the top of the income pyramid who received disproportionately large tax cuts.<sup>326</sup>

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<sup>321</sup> See Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965).

<sup>322</sup> See Michael Boskin, *Taxation, Savings, and the Rate of Interest*, 86 J. POL. ECON. S3, S18-S25 (1978); David Bradford, *The Economics of Tax Policy Toward Savings*, in *THE GOVERNMENT AND CAPITAL FORMATION* 11, 20-28 (George von Furstenberg ed., 1980). See generally Martin Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. 29 (1978).

<sup>323</sup> See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 69 (2002).

<sup>324</sup> C. Eugene Steuerle, *Gettin' Our'n While the Gettin' Is Good*, 100 TAX NOTES 845, 846 (2003).

<sup>325</sup> See generally Amartya Sen, *Rationality and Social Choice*, 85 AM. ECON. REV. 1 (1995).

<sup>326</sup> Spending tends to be more proportional than taxation, and thus tends to be more progressive. See Steuerle, *supra* note 186, at 1187-88; EDWARD N. WOLFF ET AL., *HOUSEHOLD WEALTH, PUBLIC CONSUMPTION AND ECONOMIC WELL-BEING IN THE UNITED STATES* 10-11, 27 (Levy Econ. Inst. of Bard Coll., Working Paper No. 386, 2003), available at <http://www.levy.org/modules/pubsublib/files/wp386.pdf> (stating that the mean amount of public consumption increases with each income decile, but public consumption as a percentage of income decreases as income decile increases).

### A. *The Supply Side Justification*

All of the tax cuts enacted in the first three years of the twenty-first century were justified by their proponents as promoting economic growth. There is no doubt that economic theory supports the idea that tax cuts that create or increase a government budget deficit, as these tax cuts (coupled with significant spending increases) did on a massive scale,<sup>327</sup> can be expected to act as a short-term economic stimulus.<sup>328</sup> That is classical Keynesian economics.<sup>329</sup> But these tax cuts were skewed to the rich, not to the bottom and middle of the income pyramid. Nothing in Keynesian economics or classical macroeconomic theory requires that tax-cuts be provided to the rich to stimulate the economy. Indeed, if the problem is inadequate demand, tax cuts disproportionately benefiting low- and middle-income individuals, who are more likely to spend the increased after-tax income than to save it, are far more likely to provide the desired economic stimulus.<sup>330</sup>

The 2001 through 2003 tax cuts are unlikely to stimulate long-term growth for a number of reasons.<sup>331</sup> To start with, the proposition that high levels of taxation generally impede economic growth is a theory that is not supported by empirical data. During the two decades between 1970 and 1990, some low tax countries, such as Japan, enjoyed substantial rates of economic growth, while others—the United States in particular—performed below average. Likewise, some high tax countries saw poor economic growth, while quite a few others performed above average.<sup>332</sup> Even before the Bush tax cuts of 2001 through 2003, the United States had one of the lowest overall tax rates among all industrialized democracies—among Organisation for Economic Co-operation and Development (the “OECD”) countries in 2001, only Mexico, Japan, and Korea collected lower percentages of

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<sup>327</sup> See generally CONG. BUDGET OFFICE, *supra* note 278; RICHARD KOGAN, CTR. ON BUDGET & POLICY PRIORITIES, SWELLING DEFICITS: INCREASED SPENDING IS NOT THE PRINCIPAL CULPRIT: RECENT SPENDING GROWTH LEAVES FEDERAL EXPENDITURES BELOW HISTORICAL LEVELS (Oct. 27, 2003), available at <http://www.cbpp.org/10-27-03bud.pdf>.

<sup>328</sup> See JOSEPH PECHMAN, *FEDERAL TAX POLICY* 9–12 (5th ed. 1987).

<sup>329</sup> See CHARLES L. SCHULTZE, MEMOS TO THE PRESIDENT 211–12 (1992).

<sup>330</sup> GRAVELLE, *supra* note 116, at 15 (“Both economic theory and evidence suggest that tax cuts for higher income individuals have a smaller stimulative effects [sic] than tax cuts for lower income individuals.”).

<sup>331</sup> See, e.g., *Economic Growth, Job Creation, and Incentives for Investment: Hearings Before the Senate Comm. on Finance*, 108th Cong. 1–2 (2003) (testimony of William G. Gale, Brookings Inst. & Tax Policy Ctr.), available at <http://www.brookings.edu/dybdocroot/views/testimony/gale/20030212.pdf>.

<sup>332</sup> See SLEMMOD & BAKIJA, *supra* note 174, at 99–102.

GDP in taxes.<sup>333</sup> By 2003, as a result of the 2001 through 2003 tax cuts, the tax rate on income and profits (as a percentage of GDP) for the United States fell from 15.1% to 10.9%,<sup>334</sup> and the overall tax rate (tax-to-GDP ratio) of the United States fell from 29.9% to 25.4%.<sup>335</sup> Among all OECD countries, only Mexico had a lower overall tax rate than the United States in 2003,<sup>336</sup> although several countries that rely heavily on value-added taxes and/or wage taxes had slightly lower tax rates on income and profits, even though they generally had significantly higher overall tax rates.<sup>337</sup>

The particular nature of the 2001 and 2003 tax cuts makes them look like the "trickle-down," "supply-side" tax cuts enacted in 1981,<sup>338</sup> based in part on the infamous, and now discredited, "Laffer Curve."<sup>339</sup> Trickle-down, supply-side tax cuts are tax cuts skewed to high-income and wealthy taxpayers intended to increase incentives to invest and work, thereby creating jobs for the poor and middle class who did not directly benefit from the largess the government bestowed on the

<sup>333</sup> ORG. FOR ECON. CO-OPERATION & DEV., *Tax Revenue as Percentage of GDP*, in TAX PAYMENTS ROSE IN SOME OECD COUNTRIES IN 2003, BUT FELL IN OTHERS tbl.A (2004), available at <http://www.oecd.org/dataoecd/6/63/1962227.pdf>.

<sup>334</sup> ORG. FOR ECON. CO-OPERATION & DEV., *Taxes on Income and Profits as Percentage of GDP*, in TAX PAYMENTS ROSE IN SOME OECD COUNTRIES IN 2003, BUT FELL IN OTHERS tbl.B (2004), available at <http://www.oecd.org/dataoecd/6/1/33826979.pdf>.

<sup>335</sup> See generally ORG. FOR ECON. CO-OPERATION & DEV., TAX PAYMENTS ROSE IN SOME OECD COUNTRIES IN 2003, BUT FELL IN OTHERS (2004), [http://www.oecd.org/document/21/0,2340,en\\_2649\\_201185\\_33808789\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/21/0,2340,en_2649_201185_33808789_1_1_1_1,00.html) (Oct. 20, 2004). According to the OECD, except for the United States, the "largest recent reductions in tax-to-GDP ratios have been in countries with relatively high tax burdens, such as Sweden, Finland and France, while some of the largest recent increases in tax-to-GDP ratios have been in countries with relatively low tax burdens, such as Mexico, Korea and New Zealand." *Id.*

<sup>336</sup> See ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 333, at tbl.A.

<sup>337</sup> See ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 334, at tbl.B.

<sup>338</sup> See C. EUGENE STEUERLE, THE TAX DECADE 39 (1992) (describing 1981 tax cuts as "supply side"); David R. Francis, *Trickle-Down's Tricky Math*, CHRISTIAN SCI. MONITOR, Jan. 8, 2003 (describing Bush's tax cut proposals as "trickle-down"), <http://www.csmonitor.com/2003/0108/p10s01-usec.html>; Stephen Moore, *Bill Greider: Bad Taste, Bad Economics*, THE NAT'L REV. ONLINE (July 24, 2003), at <http://www.nationalreview.com/moore/moore072403.asp> (referring to the 1980s Reagan tax cuts as "trickle down").

<sup>339</sup> The Laffer Curve illustrates that the amount of revenue collected by the government is a function of the tax rate. This curve is represented by placing the tax rate on the vertical axis and tax revenue on the horizontal axis. The graph assumes that there is a tax rate beyond which supply response is so great that tax revenues will fall. "It . . . shows that when tax rates are very high, any increase in the tax rate could actually cause tax revenues to fall." KARL E. CASE & RAY C. FAIR, PRINCIPLES OF ECONOMICS 863 (1989). Alfred L. Malabre, Jr. provides a more thorough explanation of the Laffer Curve theory and a discussion of why it is discredited. See ALFRED L. MALABRE, JR., LOST PROPHETS 181-88 (1994); see also SLEMROD & BAKIJA, *supra* note 174, at 124 (explaining how the Laffer Curve theory did not work).

rich. There are still economists who support the trickle-down theory,<sup>340</sup> and some observe that the distribution tables for the 2001 through 2003 tax cuts do not take into account the trickle-down effects.<sup>341</sup> Nevertheless, the trickle-down theory does not command mainstream support among economists.<sup>342</sup> In order to have any possibility of encouraging long-term economic growth, supply-side tax cuts must be matched by spending cuts,<sup>343</sup> or provide significant incentives to increase savings and labor.<sup>344</sup>

### B. The Fallacy of the Justification

#### 1. The Equity/Efficiency Trade-Off Is a False Choice

Historically, economists generally have concluded that graduated progressive taxation impedes economic efficiency, even if graduated progressive tax rates might be more desirable on equity grounds.<sup>345</sup> More broadly, the trade-off is described as one between “productive efficiency (and/or growth) and social justice.”<sup>346</sup> With equity and efficiency viewed as mutually exclusive objectives between which policy makers must choose, the issue is thus framed as involving a trade-off of efficiency for equity.<sup>347</sup> Debates over progressive taxation have

<sup>340</sup> See Mark D. Partridge, *Is Inequality Harmful for Growth?*, 87 AM. ECON. REV. 1019, 1030 (1997) (arguing that trickle-down might work).

<sup>341</sup> See PENNER, *supra* note 279, at 16. Rudolph Penner stated the following:

[A]s much as the cut in the tax on capital increases its supply, either by attracting more capital from abroad or by raising savings, wage earners will become more productive because they have more capital to work with, and the benefits of the cut will trickle down the income distribution.

*Id.*

<sup>342</sup> See, e.g., STIGLITZ, *supra* note 4, at 286; see also Lee A. Sheppard, *Flat Tax and Politics at NYSBA*, 70 TAX NOTES 488, 488 (1996) (quoting Larry Summers reference to the claimed economic efficiencies of the flat tax as “deja voodoo” economics).

<sup>343</sup> John W. Diamond & Pamela H. Moormau, *Issues in Analyzing the Macroeconomic Effects of Tax Policy*, 56 NAT’L TAX J. 447, 452 (2003) (indicating that tax cuts shrink GDP if not offset by spending).

<sup>344</sup> MARC LABONTE & GAIL MAKINEN, CONG. RESEARCH SERV., LIBRARY OF CONG., INCOME TAX CUTS, THE BUSINESS CYCLE, AND ECONOMIC GROWTH: A MACROECONOMIC ANALYSIS (2001), <http://www.ncseonline.org/nle/crsreports/economics/econ-131.cfm?&CFID=13341047&CFTOKEN=9251135#1-11> (last updated Mar. 28, 2001).

<sup>345</sup> See generally Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden*, 69 TAX NOTES 1517 (1995).

<sup>346</sup> Philippe Aghion et al., *Inequality and Economic Growth: The Perspective of New Growth Theories*, 37 J. ECON. LITERATURE 1615, 1620 (1999).

<sup>347</sup> See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 101 (3d ed. 1980); ARTHUR M. OKUN, EQUALITY AND EFFICIENCY: THE BIG

divided scholars into those who champion efficiency over equity and those who favor equity over efficiency.<sup>348</sup>

More recently, however, many economists are concluding that the trade-off is not as significant as it was once thought to be. Based on the experiences with numerous changes in the progressivity of rates in the 1980s and 1990s, Joel Slemrod concludes as follows:

[T]here is a clear hierarchy of categories of behavioral responses. At the top, the most responsive, is the timing of taxable activity. In the second tier, often quite responsive but not as much so as timing, are responses sometimes called avoidance—including income shifting, financial restructuring, change in the form of legal entity, “renaming” what you’re already doing to obtain a more favorable tax treatment—as well as flat out evasion. At the bottom of the hierarchy, the least responsive in general, is the responsiveness of critical real economic variables such as labor supply, saving, and investment. There is no convincing evidence that either aggregate labor supply or saving responds in a significant way to taxes, and the evidence regarding business investment is mixed.<sup>349</sup>

Other recent studies concur that changes in reported income in response to changing tax rates appear more to be the result of temporary timing changes rather than permanent behavioral responses.<sup>350</sup>

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TRADEOFF 88–120 (1975); Martin Feldstein, *On the Theory of Tax Reform*, 6 J. POL. ECON. 77, 78 & n.2 (1976). See generally Walter J. Blum, *Revisiting the Uneasy Case for Progressive Taxation*, 60 TAXES 16 (1982); Blum & Kalven, *supra* note 109.

<sup>348</sup> Arthur Okun analogized the tradeoff to taking from the rich to give to the poor, but carrying the money in a leaky bucket; the amount of leakage was the loss in efficiency, and the policy question is how much leakage should be tolerated. OKUN, *supra* note 347, at 91. Okun explained how some people—those motivated by Rawls’s difference principle pursuant to which “all social values . . . are to be distributed equally unless an unequal distribution of any . . . is to everyone’s advantage”—would favor equality over efficiency. *Id.* at 92, quoting JOHN RAWLS, A THEORY OF JUSTICE 62 (1971). Others, however, such as Milton Friedman, would favor efficiency over everything else.

<sup>349</sup> Joel Slemrod, 2002 Erwin N. Griswold Lecture Before the American College of Tax Counsel, *The Dynamic Tax Economist*, 56 TAX LAWYER 611, 613 (2003); see EMMANUEL SAEZ, REPORTED INCOMES AND MARGINAL TAX RATES, 1960–2000: EVIDENCE AND POLICY IMPLICATIONS 4 (Nat’l Bureau of Econ. Research, Working Paper No. 10273, 2004) (finding that only the incomes of taxpayers within the top 1% of the income distribution appear to be responsive to changes in tax rates over the 1960 through 2000 period and that the top 1% was responsive to changes in the 1980s, but not in other periods; suggesting that the surge in incomes of top executives in the late twentieth century was due to market failure).

<sup>350</sup> See generally Frank Sammartino & David Weiner, *Recent Evidence on Taxpayer’s Response to the Rate Increases in the 1990s*, 50 NAT’L TAX J. 683 (1997).

Timing and evasion problems cannot be dismissed as unimportant behavioral responses,<sup>351</sup> but there are other ways to deal with evasion—tightening up the substantive rules governing the base and better enforcement<sup>352</sup>—and timing is more of a problem because of constantly shifting rules and rates than it would be if the rate structure were more stable.<sup>353</sup> For example, the data do not support the argument that capital gains realizations are responsive to tax rates in the long run; there are, however, short-run spikes from lowering rates due to opportunistic behavior.<sup>354</sup> Because a mere shift in the timing of an economic activity may have no long-run effect on the economy,<sup>355</sup> these other inefficiencies can be dealt with in other ways, and the problem of “real” inefficiencies is not really serious; equity can be achieved without the big trade-off.

Optimal tax theory can reinforce the conclusion that there might not be too great a trade-off between equity and efficiency.<sup>356</sup> Under

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<sup>351</sup> Slemrod, *supra* note 349, at 616.

<sup>352</sup> The enactment of the § 469 passive activity loss rules to deal with tax shelters and the § 1(g) “kiddie tax” to deal with assignments of income to evade progressivity in the 1986 Act are two such examples. See generally Martin J. McMahon, Jr., *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 98 TAX NOTES 1721 (2003). The President’s 2005 Fiscal Year Budget proposes to revise the kiddie tax to provide that the first \$2500 (indexed after 2005) of taxable investment income and all earned income of dependent children under age fourteen would be taxed at the child’s own tax rate. Taxable investment income above \$2500 would be taxed at the highest regular income tax rate (regardless of the parent’s tax rate). Dividends or capital gains included in taxable investment income above \$2500 would be taxed at the highest dividends or capital gains tax rates, respectively, generally applicable. U.S. DEP’T OF THE TREASURY, *supra* note 246, at 5. To some extent, this move will foster tax planning, give rise to inefficiencies of the type described by Joel Slemrod, and further disproportionately reduce the income tax burden on the wealthy, who can most afford and most often structure transactions that effectively shift taxable income to children. See generally Martin J. McMahon, Jr., *Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents*, 56 N.Y.U. L. REV. 60 (1981). With both dividends and capital gains taxed at low rates (5% or 15%), in light of the \$2500 threshold for applying the highest marginal rates, planning opportunities are much less than would exist if the kiddie tax were simply repealed.

<sup>353</sup> Of course, there remains the issue of “self help” income averaging.

<sup>354</sup> Woodward, *supra* note 284, at 5–6; accord Leonard E. Burman & William C. Randolph, *Measuring Permanent Responses to Capital Gains Tax Changes in Panel Data*, 84 AM. ECON. REV. 794, 807 (1994).

<sup>355</sup> STAFF OF JOINT COMM. ON TAXATION, OVERVIEW OF WORK OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO MODEL THE MACROECONOMIC EFFECTS OF PROPOSED TAX LEGISLATION TO COMPLY WITH HOUSE RULE XIII.3(h)(2), at 13 (JCX-105-03) (Comm. Print 2003). available at <http://www.house.gov/jct/x-105-03.pdf>.

<sup>356</sup> James Mirrlees, a British economist, is generally credited with developing optimal tax theory through the publication of an article in 1971. See generally J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971). Several legal schol-



optimal tax theory, the best ("optimal") tax is one imposed on activities with relatively low elasticities. Thus, imposition of the tax will not decrease productivity; indeed, it might have the opposite effect. If individual work effort and savings are not responsive to the rate of tax, optimal tax theory suggests that imposing higher rates of taxation on the rich can improve equity while not decreasing productivity.<sup>357</sup> Thus, if labor and savings are relatively inelastic in response to changes in the tax rates, the classically described equity/efficiency trade-off is not a problem in practice apart from evasion and timing issues, both of which can be addressed through solutions that do not involve the rate structure.

## 2. Labor and Savings Are Not Highly Responsive to Tax Rates

The theory that apparently underlies the distribution of the Bush tax cuts is that lower taxes on the rich will lead them to save more and to work harder. Some economists support this idea.<sup>358</sup> Most who have studied the question find nothing to support the notion.<sup>359</sup> The crucial question is whether the income effect or the substitution effect predominates.<sup>360</sup> Substitution and income effects offset to some degree.<sup>361</sup> Economists do not all agree on whether the substitution or the income effect predominates.<sup>362</sup> If the income effect predominates, reducing taxes actually could cause the labor supply and savings rate to decrease rather than to increase. Furthermore, if high incomes are the result of superior endowment and luck rather than greater work

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ars have analyzed its general applicability to the formulation of American tax policy. See generally Bankman & Griffith, *supra* note 109; Zelenak & Moreland, *supra* note 109.

<sup>357</sup> See McMahon & Abreu, *supra* note 46, at 51–57.

<sup>358</sup> See, e.g., 2 *Replacing the Federal Income Tax: Hearing Before House Comm. on Ways and Means*, 104th Cong., H.R. Doc. No. 104-46, at 123, 129 (1996) (statement of Alan J. Auerbach); Boskin, *supra* note 322, at S3–S27; Lyon, *supra* note 117, at 224 (referencing such studies); see also Joel Slemrod, *Professional Opinions About Tax Policy: 1994 and 1934*, 48 NAT'L TAX J. 121, 131 (1995) (stating that 67% of surveyed economics professors who were members of the NTA-TIA believed that lower tax rates on the return to savings increase private saving).

<sup>359</sup> See ALBERT ANDO ET AL., *THE STRUCTURE AND REFORM OF THE U.S. TAX SYSTEM* 67–71 (1985); SLEMROD & BAKIJA, *supra* note 174, at 103–08.

<sup>360</sup> See Robert Eisner, *The Proposed Sales and Wages Tax—Fair, Flat or Foolish*, in *FAIRNESS AND EFFICIENCY IN THE FLAT TAX* 42, 78 (Robert E. Hall et al. eds., 1996), available at [http://www.aei.org/docLib/20021130\\_70450.pdf](http://www.aei.org/docLib/20021130_70450.pdf) (date posted Jan. 1, 2000); see also Jon Gruber & Emmanuel Saez, *The Elasticity of Taxable Income: Evidence and Implications*, 84 J. PUB. ECON. 1, 3 (2002).

<sup>361</sup> Marginal tax rates determine the substitution effect, while average rates determine the income effect. GRAVELLE, *supra* note 116, at 14.

<sup>362</sup> See LABONTE & MAKINEN, *supra* note 344.

effort and skill, "optimal marginal tax rates in all likelihood should be high because high realized income" is random and the disincentive effects should be minimal.<sup>363</sup>

#### a. Labor Supply

Economists who conclude that the level of tax rates affects the labor supply reach this conclusion from models based on the idea that the substitution effect—substituting leisure for labor when the yield to labor decreases in an effort to maintain income levels when wages fall—predominates over the income effect.<sup>364</sup> Nevertheless, economic theory alone cannot predict which effect will predominate.<sup>365</sup> The models that predict that work effort will increase if tax rates are decreased are based on assumptions regarding responsiveness of the labor supply to wages. In contrast, empirical studies indicate that the labor supplied by primary wage earners does not respond significantly to after-tax pay changes.<sup>366</sup> Secondary wage earners, however, do appear to be responsive to changes in after-tax pay.<sup>367</sup> Recent work suggests that male labor supply is not very responsive to wage rates except at the lower wage levels, and may be negative; female responsiveness might not be as great as previously estimated, and for females consistently in the work force, it may resemble

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<sup>363</sup> JOEL SLEMROD & JON BAKIJA, DOES GROWING INEQUALITY REDUCE PROGRESSIVITY? SHOULD IT? 7 (Nat'l Bureau of Econ. Research, Working Paper No. 7576, 2000).

<sup>364</sup> See JOSEPH J. MINARIK, MAKING TAX CHOICES 52–54 (1985); RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 241–46 (1959); Robert K. Triest, *Fundamental Tax Reform and Labor Supply*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, *supra* note 364, at 247, 255–64 (modeling the labor response to replacement of the corporate and individual income taxes by a 14.3% VAT). Some of these models lead to the conclusion that to maximize efficiency, rates ought to be regressive; that is, marginal rates ought to decrease as income increases. See Lyon, *supra* note 117, at 225. See generally Joel Slemrod et al., *The Optimal Two-Bracket Linear Income Tax*, 53 J. PUB. ECON. 269 (1994).

<sup>365</sup> See MUSGRAVE, *supra* note 364, at 241–46; James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, 72 TAX NOTES 97, 102–03 (1996).

<sup>366</sup> See Eric Engen & Jonathan Skinner, *Taxation and Economic Growth*, 49 NAT'L TAX J. 617, 631 (1996). See generally Emmanuel Saez, *The Effect of Marginal Tax Rates on Income: A Panel Study of Bracket Creep*, 87 J. PUB. ECON. 1231 (2002).

<sup>367</sup> BENJAMIN M. FRIEDMAN, DAY OF RECKONING: THE CONSEQUENCES OF AMERICAN ECONOMIC POLICY UNDER REAGAN AND AFTER 242–43 (1988); Triest, *supra* note 364, at 256–57; see Jane G. Gravelle, *Behavioral Feedback and the Revenue Estimating Process*, 48 NAT'L TAX J. 463, 468–70 (1995). See generally Jane G. Gravelle, *Behavioral Responses to Proposed High-Income Tax Rate Increases: An Evaluation of the Feldstein-Feenberg Study*, 59 TAX NOTES 1097 (1993).

that of males.<sup>368</sup> The only group for which wage income has increased significantly as tax rates have been cut in the past twenty years is the top 1%.<sup>369</sup> But that is not likely attributable to tax cuts, because wage income did not respond to the dramatic Kennedy tax cuts in the 1960s.<sup>370</sup> The surge in wage income of the top 1% in recent years is merely the reflection of a long trend of rapidly increasing incomes for this group starting in the mid-1970s, coupled with a shift of income from the corporate to the individual sector—effected through the increasing use of partnerships rather than corporations to conduct business—since the mid-1980s.<sup>371</sup> Although the top 0.10% has seen the most dramatic increase in incomes and “non-trivial” rate reductions, there is no clear evidence of a causal relationship.<sup>372</sup>

Historically, over the long-term in the United States, increasing real wages have led to shorter work weeks, longer vacations, and earlier retirement.<sup>373</sup> This is evidence that the income effect predominates over the substitution effect.<sup>374</sup> Furthermore, there is nothing to

<sup>368</sup> See Nada Eissa, *Tax and Transfer Policy and Female Labor Supply*, in PROCEEDINGS OF THE EIGHTY-EIGHTH ANNUAL NATIONAL TAX ASSOCIATION CONFERENCE ON TAXATION 160 (1996); MINARIK, *supra* note 364, at 52–54. See generally William Randolph & Diane Lim Rogers, *The Implications for Tax Policy of Uncertainty About Labor-Supply and Savings Responses*, 48 NAT'L TAX J. 429 (1995).

<sup>369</sup> See generally SAEZ, *supra* note 349.

<sup>370</sup> *Id.* at 4. Emmanuel Saez stated the following:

Top income shares within the top 1% show striking evidence of large and immediate responses to the tax cuts of the 1980s, and the size of those responses is largest for the very top income groups. In contrast, top incomes display no evidence of short or long-term response to the extremely large changes in the net-of-tax rates following the Kennedy tax cuts in the early 1960s.

*Id.*

<sup>371</sup> *Id.* at 4–5. Emmanuel Saez further stated the following:

[M]ost of the surge in top incomes since the 1970s has been due to a smooth and extraordinary increase in the wages and salary component (which includes stock-option exercises). This wage income surge started slowly in the early 1970s and has accelerated over the period, and especially during the last decade, and does not seem to be closely related to the timing of the tax cuts.

*Id.*

<sup>372</sup> *Id.*

<sup>373</sup> See Eisner, *supra* note 361, at 79; Randolph & Rogers, *supra* note 368, at 435.

<sup>374</sup> See generally Randolph & Rogers, *supra* note 368. One of the reasons that the income effect could predominate over the substitution effect is that the substitution effect operates only at the margin; that is, workers will substitute work for leisure only if they receive a pay increase for the additional hour worked. The income effect, however, operates with respect to total pay for all hours worked. See William G. Gale & Peter R. Orszag, *Bush Administration Tax Policy: Effects on Long Term Growth*, 105 TAX NOTES 415, 417 (2004). Thus, for any worker employed full time or nearly full time, a wage increase that applies to

indicate that high-income earners behave any differently than anyone else, unless perhaps their labor supply is more inelastic than that of low-income workers because of the nature of their jobs and the reasons that they work.<sup>375</sup> Although some studies conclude that the taxable income of very top wage earners—the top 1%—shows some responsiveness to tax rates, their economic income is not nearly as responsive.<sup>376</sup> There is evidence that elasticity of labor supply systematically decreases as income increases.<sup>377</sup> In short, the empirical evidence indicates that those who predict that lower tax rates will increase work effort have made erroneous assumptions about human behavior.<sup>378</sup> In many cases, at-the-margin work effort of the highest-income earners probably is motivated more by nonmonetary factors such as interest and prestige.<sup>379</sup> It is doubtful that increased taxes would cause corporate executives, financiers, and Wall Street lawyers to reduce their work efforts to the extent that the economy noticeably will be harmed.<sup>380</sup> On balance, the most reasonable conclusion is that although there are theories that predict that the labor supply in general varies inversely to tax rates, these theories are unproven and, in all likelihood, erroneous.

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all hours worked provides a far greater increase in aggregate wages than the increase in wages that would result from working less than a very substantial number of additional hours. As a result, the incentive to work additional hours is dampened.

<sup>375</sup> THOMAS H. SANDERS, *EFFECTS OF TAXATION ON EXECUTIVES* 17–32 (1951) (Harvard Business School study concluded that executive work effort was unaffected by tax rates at a time when maximum rates exceeded 90%); McMahon & Abreu, *supra* note 46, at 63–65; Slemrod, *supra* note 286, at 203–09 (concluding that tax rates affect the form of compensation, but not its total amount); Triest, *supra* note 364, at 257, 261, 269 (noting that rate reductions in 1986 resulted, at best, in only a small increase in the labor supply of high-income men and further noting that although econometric models indicate that switching from an income tax to a flat rate consumption tax results in most significant hourly work increases for the highest-income decile, empirical evidence supporting the theory of a high-income Laffer Curve is “scant”).

<sup>376</sup> Gruber & Saez, *supra* note 360, at 1.

<sup>377</sup> See, e.g., Zelenak & Moreland, *supra* note 109, at 76–81.

<sup>378</sup> But see generally Edward C. Prescott, *Why Do Americans Work So Much More than Europeans?*, 28 FED. RES. BANK OF MINNEAPOLIS Q. REV., July 2004, at 2 (asserting that the author’s calculations demonstrate that Americans work 50% more hours than Europeans solely because Europeans face higher marginal tax rates).

<sup>379</sup> See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY & PRACTICE* 300 (5th ed. 1989).

<sup>380</sup> See THOMAS H. SANDERS, *supra* note 375, at 17–32.

## b. Savings

Economists traditionally have thought that it is inefficient to tax capital income, because doing so retards growth by decreasing savings, the source of investment.<sup>381</sup> Applied to income from capital, the substitution effect predicts that, if the yield to capital increases, saving becomes more attractive relative to present consumption. Under the income effect, however, if the yield to savings increases, a target saver can reduce savings and still have the same accumulated fund in a future year. Which of these two effects predominates depends on the motivation for saving.<sup>382</sup> Different economists, employing different models, reach different results. Some economists conclude that personal savings responds significantly to the interest rate.<sup>383</sup> Many other economists conclude that there is little if any response; it is "small and hard to find."<sup>384</sup> Many econometric models predict that reducing taxes on income from capital at best would lead to only modest increases in the savings rate.<sup>385</sup> The reality is that the motivations for saving and the decision of whether to save or consume are so complex that economic theory cannot deal with them very well.<sup>386</sup>

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<sup>381</sup> See, e.g., Boskin, *supra* note 322, at S27; Roger H. Gordon, *Capital Income Taxes*, NBER REPORTER (Nat'l Bureau of Econ. Research, Cambridge, Mass.), Fall 2003, at 16, 16 (stating that "capital income taxes have large efficiency costs, collect little revenue, and have no obvious distributional gains. So, the case for using them appears to be very weak."); see also Joel Slemrod, *supra* note 349, at 131 (stating that 67% of surveyed economics professors who were members of the NTA-TIA believed that lower tax rates on the return to savings increase private saving).

The argument also is made that the only difference between an income tax and a cash flow consumption tax, assuming that savings are consumed by the saver—which is a wildly unrealistic assumption—is that the risk-free rate of return is taxed in an income tax but not in a consumption tax; inframarginal returns are taxed in both systems. R. Glenn Hubbard, *How Different Are Income and Consumption Taxes?*, 87 AM. ECON. REV. 138, 139–40 (1997).

<sup>382</sup> In addition, some saving—much household saving—may be precautionary, the proverbial "saving for a rainy day." Such saving may not be affected one way or another by the yield to capital. See Eric M. Engen & William G. Gale, *The Effects of Fundamental Tax Reform on Saving*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, *supra* note 364, at 83, 93–94.

<sup>383</sup> See, e.g., Boskin, *supra* note 322, at S3–S27.

<sup>384</sup> Charles L. Schultze, *Promises, Promises, The Elusive Search for Faster Economic Growth*, 14 BROOKINGS REV., Fall 1996, at 6, 8, available at <http://www.brook.edu/press/review/schufa96.htm> (last modified July 17, 2001); see E. Philip Howrey & Saul H. Hymans, *The Measurement and Determination of Loanable-Funds Saving*, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE 1, 29–30 (Joseph A. Pechman ed., 1980).

<sup>385</sup> See, e.g., Don Fullerton & Diane Lim Rogers, *Lifetime Effects of Fundamental Tax Reform*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, *supra* note 364, at 321, 339–47; Alan J. Auerbach, *Tax Reform, Capital Allocation, Efficiency, and Growth*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, *supra* note 364, at 29, 29–73.

<sup>386</sup> See generally LUSARDI ET AL., *supra* note 282.

Furthermore, there are developing theories supporting the notion that taxing capital income more lightly than labor income—as is currently the case in the United States—is less than optimal and can retard economic growth. Recent work by Emmanuel Saez concludes that steeply progressive capital income taxation does not introduce inefficiencies and produces desirable results.<sup>387</sup> Other recent theoretical work indicates that taxing capital income fosters growth:

A government . . . is faced with tradeoffs: lower capital income taxation means either lower government expenditures or higher debt financing or higher labor income taxes. Keep the level of government expenditure and debt financing fixed for the sake of the argument. If we think of labor income being paid mostly to the young and capital income accruing mostly to the old, a lower capital income tax and thus a higher labor income tax means that the younger people in an economy are left with less income out of which to save and to buy the capital stock. If savings decisions are not too elastic with respect to long term interest rates, this will lead to lower savings and thereby to slower growth rather than faster growth.<sup>388</sup>

Yet other recent work in economics indicates that high personal tax rates do not discourage entrepreneurial activity:<sup>389</sup>

[L]ow tax rates alone are not plausibly the main factor affecting the amount of entrepreneurial activity . . . . The fact that countries and time periods with high growth rates often had quite high tax rates also suggests the importance of other factors. . . .

. . .

In the United States, for example, the 1950s and 1960s were a period of particularly high growth rates, yet top per-

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<sup>387</sup> EMMANUEL SAEZ, OPTIMAL PROGRESSIVE CAPITAL INCOME TAXES IN THE INFINITE HORIZON MODEL (Nat'l Bureau of Econ. Research, Working Paper No. 9046, 2002).

<sup>388</sup> HARALD UHLIG & NORIYUKI YANAGAWA, INCREASING THE CAPITAL INCOME TAX LEADS TO FASTER GROWTH 2 (Ctr. for Econ. Research, Discussion Paper No. 115, 1995), available at <http://greywww.kub.nl:2080/greyfiles/center/1994/doc/115.pdf> (last revised Aug. 25, 1995).

<sup>389</sup> JULIE BERRY CULLEN & ROGER H. GORDON, TAXES AND ENTREPRENEURIAL ACTIVITY: THEORY AND EVIDENCE FOR THE U.S. 36 (Nat'l Bureau of Econ. Research, Working Paper No. 9015, 2002) (stating that “contrary to conventional wisdom, we find that a cut in personal tax rates reduces entrepreneurial activity”).

sonal tax rates during this period were as high as 87 percent.<sup>390</sup>

Thus, the old-time conventional economic theory, that taxes stifle productivity, no longer can be viewed as clear and certain.<sup>391</sup> It is beginning to look more and more like that theory has it backwards.

Empirical evidence indicates that an increased yield to capital might actually decrease household savings.<sup>392</sup> Over the long term, the United States personal savings rate has varied inversely with the yield to capital.<sup>393</sup> Our most recent experience with attempts to increase the savings rate by reducing tax rates indicates that the effort is counterproductive. During the 1980s, when real interest rates increased and marginal tax rates, particularly the rates on the income from capital, decreased, producing a significant increase in after-tax yield, the savings rate fell.<sup>394</sup> The private savings rate has been plunging since the mid-1980s.<sup>395</sup> There is no good reason to expect the Bush tax cuts to increase national savings. Although the complete analysis is quite technical, recent analysis of the 2001 cuts by Alan Auerbach indicates that they actually would decrease national savings.<sup>396</sup> Even the

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<sup>390</sup> Roger H. Gordon, *Can High Personal Tax Rates Encourage Entrepreneurial Activity?*, 45 INT. MONETARY FUND STAFF PAPERS 49, 50 & n.3 (1998) (footnote call number omitted), available at <http://www.imf.org/external/pubs/ft/staffp/1998/03-98/pdf/gordon.pdf>.

<sup>391</sup> See SLEMROD & BAKIJA, *supra* note 174, at 109–12 (1996); Alan J. Auerbach, *Measuring the Impact of Tax Reform*, 49 NAT'L TAX J. 665, 665–66 (1996).

<sup>392</sup> See FRIEDMAN, *supra* note 367, at 252–55; JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 25–28 (1994).

<sup>393</sup> See Jonathan Skinner & Daniel Feenberg, *The Impact of the 1986 Tax Reform on Personal Savings*, in DO TAXES MATTER? THE IMPACT OF THE TAX REFORM ACT OF 1986, at 58–63 (Joel Slemrod ed., 1990). See generally Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737 (1994) (arguing that empirical analysis indicates that venture capitalists and entrepreneurs in Silicon Valley start-ups, surely high-risk ventures, operate in almost complete oblivion of taxation issues).

<sup>394</sup> ALBERT ANDO ET AL., *supra* note 359, at 67–71; GRAVELLE, *supra* note 392, at 26. See generally *Various Flat Tax Proposals: Hearing Before the Senate Finance Comm.*, 104th Cong. (1995) (unofficial transcript of statement of Alan Auerbach), in TAX NOTES TODAY, Apr. 13, 1995, Doc No. 95-3872, LEXIS, 95 TNT 72-26; *Taxes and Economic Growth: Testimony Before the Joint Economic Comm.*, 104th Cong. (1996) (statement of William G. Gale).

<sup>395</sup> RESEARCH & POL. COMM. OF THE COMM. FOR ECON. DEV., HOW ECONOMIES GROW: THE CED PERSPECTIVE ON RAISING THE LONG-TERM STANDARD OF LIVING 6–7 (2003), available at [http://www.ced.org/docs/report/report\\_ltgrowth2.pdf](http://www.ced.org/docs/report/report_ltgrowth2.pdf).

<sup>396</sup> Alan J. Auerbach, *The Bush Tax Cut and National Saving*, 55 NAT'L TAX J. 387, 395–97 (2002); see Gale & Orszag, *supra* note 374, at 417. William G. Gale and Peter R. Orszag stated the following:

[T]he 2001 and 2003 tax cuts did not do a good job of targeting new investment. The important issue is that the reductions in dividends and capital gains taxes reward not only new investment, but also the returns to old in-

CBO has concluded that the tax cuts “will probably have a net negative effect on saving, investment, and capital accumulation over the next 10 years,”<sup>397</sup> and the Staff of the Joint Committee on Taxation concurs with this conclusion.<sup>398</sup> Thus, the tax cuts could actually have the opposite of the effect that their supporters predict.<sup>399</sup> According to two Federal Reserve Board economists, “a sustained cut in personal income taxes raises GDP by less than the amount of the tax cut itself, and it likely reduces GDP if phased in gradually over time.”<sup>400</sup>

Furthermore, even if taxation does influence savings behavior, increased savings might not increase the GDP and benefit Americans generally. The United States GDP would increase only if the savings were invested domestically, and there is no certainty that this would occur. Financial markets are international.<sup>401</sup> Much of the investment in the United States comes from foreign capital,<sup>402</sup> and domestic savings may lead to foreign investment.<sup>403</sup> If increased domestic savings lead to foreign rather than domestic investment, the wealth of the savers would increase, but domestic labor productivity would not necessarily increase.<sup>404</sup> Thus, the benefits of increased wealth would not be spread among the entire populace, but would inure only to savers, the owners of capital. In this case, all of the economic benefits realized as a result of the tax cut would inure only to those who received the tax cut, while no one else shared in the economic dividend. The

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vestment. Therefore, much of their potential impact on growth is diluted by providing windfall gains to owners of existing capital.

*Id.*

<sup>397</sup> CONG. BUDGET OFFICE, *supra* note 278, at 45.

<sup>398</sup> See generally STAFF OF JOINT COMM. ON TAXATION, MACROECONOMIC ANALYSIS OF H.R. 2, THE JOBS GROWTH AND RECONCILIATION ACT OF 2003, 149 CONG. REC. H3829-32 (May 8, 2003), [http://www.ndol.org/documents/jct\\_report\\_0503.html](http://www.ndol.org/documents/jct_report_0503.html) (last visited Nov. 15, 2004).

<sup>399</sup> Charles Kindleberger has concluded that much of the tax savings realized by the rich as a result of the drastic reduction of top marginal tax rates in the 1980s “seems to have been spent on consumption: second and third houses, travel, luxury apparel, cars, jewelry, yachts, and the like, rather than being saved or invested.” CHARLES P. KINDLEBERGER, *WORLD ECONOMIC PRIMACY: 1500-1990*, at 179 (1996).

<sup>400</sup> Douglas W. Elmendorf & David L. Reifschneider, *Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets*, 55 NAT’L TAX J. 357, 382 (2002).

<sup>401</sup> See SCHULTZE, *supra* note 329, at 107-19 (1992). See generally JOHN H. FRIEDLAND, *THE LAW & STRUCTURE OF THE INTERNATIONAL FINANCIAL SYSTEM: REGULATION IN THE UNITED STATES, EEC, AND JAPAN* (1994); *STATES AGAINST MARKETS: THE LIMITS OF GLOBALIZATION* (Robert Boyer & Daniel Drache eds., 1996).

<sup>402</sup> See SCHULTZE, *supra* note 329, at 49-52.

<sup>403</sup> See GRAVELLE, *supra* note 392, at 14; Engen & Gale, *supra* note 382, at 102.

<sup>404</sup> See MINARIK, *supra* note 364, at 63; Alan J. Auerbach, *supra* note 385, at 29, 63-65.



Matthew Effect operates, the rich get richer, and inequality increases, unless trickle-down works, which it does not.

c. *Targeted Capital Income Tax Cuts*

Even if savings were responsive to capital income tax rates, targeted tax cuts focusing on capital gains and corporate dividends are not likely to be the type of tax cuts that would produce the most response. Even those who conclude that lower taxes on capital stimulate economic growth on efficiency grounds,<sup>405</sup> acknowledge that the potential for growth from lower taxes on capital gains is smaller than a general cut in taxes on capital.<sup>406</sup> Over one-half of capital gains are realized with respect to stock,<sup>407</sup> and as far as corporate stock is concerned, lock-in is not a major economic problem because of the large percentage of stock owned by tax exempts.<sup>408</sup> Likewise, tax relief does not have as much of an impact as it might in theory because most corporate dividends are not, in fact, taxed twice. Only 40% of dividends paid by corporations are reported on personal income tax returns, primarily due to ownership of dividend-paying stock by pension funds and tax exempts.<sup>409</sup>

d. *Summary*

In the end, the arguments that the tax cuts were necessary to assure economic growth fail for lack of proof. The theoretical basis for the position is weak because it accounts for only some of the complex effects of taxation. A number of more complete recent studies have concluded that making the 2001 and 2003 tax cuts permanent would actually impede long-term economic growth rather than encourage it.<sup>410</sup> Furthermore, the empirical evidence is clearly to the contrary. A more accurate picture of the true relationship of taxes to economic

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<sup>405</sup> See Gordon, *supra* note 381, at 16 (stating that "capital income taxes have large efficiency costs, collect little revenue, and have no obvious distributional gains. So, the case for using them appears to be very weak.").

<sup>406</sup> See, e.g., Leonard E. Burman, *Taxing Capital Income Once*, 98 TAX NOTES 751, 751-52 (2003) (arguing that the capital gains preference should be repealed with respect to all property, particularly if dividends were tax exempt).

<sup>407</sup> Woodward, *supra* note 284, at 2 fig.1.

<sup>408</sup> *Id.* at 7-8. See generally William G. Gale, *About Half of Dividend Payments Do Not Face Double Taxation*, 97 TAX NOTES 839 (2002) (noting that about one-half of corporate stock is held by tax exempt organizations).

<sup>409</sup> Piketty & Saez, *supra* note 42, at 19. See generally Gale, *supra* note 408.

<sup>410</sup> Gale & Orszag, *supra* note 299, at 1288-89.

growth has been painted by Henry J. Aaron, William G. Gale, and Peter R. Orszag:

Historical evidence shows no clear correlation between tax rates and economic growth. The United States has enjoyed rapid growth both when taxes were low and when taxes were high. The strongest recent extended period of growth in U.S. history spanned the two decades from the late 1940s to the late 1960s, when the top marginal personal income tax rates were 70% or higher. Economic growth accelerated after the top marginal tax rate was increased from 31% to 39.6% in 1993. Comparisons across countries confirm that rapid growth has been a feature of both high- and low-tax nations. These considerations suggest that well-designed revenue increases need not inflict significant damage and may even strengthen economic performance.<sup>411</sup>

Thus, in setting levels of taxation—at least within levels that have been known historically—fairness should be of far more concern than economic stimulus. Before getting to the question of what level of taxation is “fair,” however, we should inquire whether inequality affects economic growth.

### 3. Inequality Impedes Economic Growth

Historically, economists took the view that wealth inequality enhanced growth.<sup>412</sup> The traditional view that inequality led to increased growth was based on the following three arguments: (1) the rich have a higher marginal propensity to save than the poor, (2) wealth must be concentrated in order to cover the large sunk costs of starting new enterprises, and (3) the poor would be motivated to work harder to become wealthy.<sup>413</sup> This relationship between inequality and growth was synthesized into the Kuznets hypothesis by economist Simon Kuznets.<sup>414</sup> According to the Kuznets hypothesis, income inequality starts low in a rudimentary economy, increases with development, and then diminishes in a fully industrialized economy. This pattern fairly could be said to be consistent with the United States experience, as

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<sup>411</sup> Henry J. Aaron et al., *Meeting the Revenue Challenge*, in *RESTORING FISCAL SANITY: HOW TO BALANCE THE BUDGET* 111, 112 (Alice M. Rivlin & Isabel Sawhill eds., 2004).

<sup>412</sup> See Aghion et al., *supra* note 346, at 1620 (discussing the economic analysis underlying this theory).

<sup>413</sup> *Id.*

<sup>414</sup> See *id.* at 1616.

well as the experience in most OECD countries, from the late eighteenth century until about 1970.<sup>415</sup> Since 1970, however, inequality has been increasing in the United States, as well as in many other OECD countries.<sup>416</sup> This empirical contradiction of the Kuznets hypothesis has led to a reexamination by economists of the relationship between inequality and economic growth.

Recently, an imposing body of literature from economists around the world "unambiguous[ly]" supports the proposition that high concentrations of wealth and income reduce the rate of economic growth.<sup>417</sup> Over long periods of time, a relatively more equal distribution of pre-tax income increases economic growth; inequality has a negative impact on economic growth.<sup>418</sup> These studies cover a large number of countries and focus on time periods of between ten and twenty-five years. The results are consistent.

Some early studies on the negative impact of inequality followed the theory that there is a trade-off between equity and efficiency. The studies found the negative correlation only in democracies, not in dictatorships, and concluded that growth during any particular period was inhibited because inequality led to a political decision to redistribute income, and that the result of the redistribution to achieve greater equality was to inhibit growth.<sup>419</sup>

Other studies that more fully integrate taxes into their model, however, contradict those conclusions and find that redistributive taxes that are intended to ameliorate inequality do not inhibit economic growth.<sup>420</sup> Equality affects growth by promoting investment,

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<sup>415</sup> *Id.*

<sup>416</sup> *Id.* at 1616, 1632.

<sup>417</sup> Aghion et al., *supra* note 346, at 1617; see Repetti, *supra* note 105, at 831-36 (discussing and analyzing in detail the literature on this topic with respect to estate taxation). Most of the studies focus on income, which is treated as a proxy for wealth, because comprehensive wealth data is difficult to obtain and income and wealth are highly correlated.

<sup>418</sup> See generally Torsten Persson & Guido Tabellini, *Is Inequality Harmful for Growth?*, 84 AM. ECON. REV. 600 (1994) (presenting a study that covered segmented twenty-year time periods between 1830 and 1985; the panel of developed countries included Austria, Denmark, Finland, Germany, the Netherlands, Norway, Sweden, the United Kingdom, and the United States; separate panel of developing countries); George R.G. Clarke, *More Evidence on Income Distribution and Growth*, 47 J. DEV. ECON. 403 (1995).

<sup>419</sup> See Persson & Tabellini, *supra* note 418, at 612-17. See generally Alberto Alesina & Dani Rodrik, *Distributive Politics and Economic Growth*, 109 Q.J. ECON. 465 (1994).

<sup>420</sup> Roberto Perotti, *Growth, Income Distribution, and Democracy: What the Data Say*, 1 J. ECON. GROWTH 149, 171 (1996). See generally Charles Garrison & Feng-Yao Lee, *Taxation, Aggregate Activity and Economic Growth: Further Cross-Country Evidence on Some Supply-Side Hypotheses*, 30 ECON. INQUIRY 172 (1992).

whereas inequality discourages investment.<sup>421</sup> This is particularly true when capital markets are imperfect.<sup>422</sup> No one who has followed the *Wall Street Journal*, the financial pages of any major newspaper, or even watched nightly television news accounts can doubt that capital markets are far, far from perfect.<sup>423</sup> Redistribution from the rich to the poor thus encourages economic growth. Yet other studies conclude that even if redistribution, effected by increasing the tax burden on capitalists and investors, does reduce the propensity to invest, the reduction in social tensions and consequential increased political stability in a more egalitarian society improve the socio-political climate for investment and productivity and foster growth.<sup>424</sup>

Inequality also reduces educational opportunities for those at the bottom of the income pyramid.<sup>425</sup> Returns to education for those lower on the income pyramid should be expected to compare to those higher up. Thus, general welfare could be increased by devoting more public resources to education. Public investment in education has been demonstrated to be an important source of improving productivity.<sup>426</sup> Public education could be funded by placing higher taxes on those at the top of the income pyramid and by rejecting proposals that would exacerbate income disparities, such as lower taxes on capital gains and dividends. If higher revenues derived from redistributive taxes were devoted to improving public education, productivity and growth would increase.<sup>427</sup>

#### 4. The Rising Tide Fallacy

The argument for supply-side tax cuts rests on two propositions. The first proposition is that the tax cuts will promote economic growth. This economic growth is measured by two related indices:

<sup>421</sup> See Aghion et al., *supra* note 346, at 1630; Persson & Tabellini, *supra* note 418, at 615.

<sup>422</sup> Aghion et al., *supra* note 346, at 1654–55.

<sup>423</sup> See RESEARCH AND POL. COMM. OF THE COMM. FOR ECON. DEV., *supra* note 395, at 18–19; STIGLITZ, *supra* note 4, at 195–96.

<sup>424</sup> Alberto Alesina & Roberto Perotti, *Income Distribution, Political Instability, and Investment*, 40 EUR. ECON. REV. 1203, 1225–26 (1996).

<sup>425</sup> Aghion et al., *supra* note 346, at 1648–49; ALAN B. KRUEGER, *INEQUALITY, TOO MUCH OF A GOOD THING* (Ctr. for Econ. Policy Studies, Princeton Univ., Working Paper No. 87, 2002). available at <http://www.princeton.edu/~ceps/workingpapers/87krueger.pdf>.

<sup>426</sup> See BAILY ET AL., *supra* note 75, at 34.

<sup>427</sup> Aghion et al., *supra* note 346, at 1622, 1648–49; KRUEGER, *supra* note 425, at 8–9; Woojin Lee & John E. Roemer, *Income Distribution, Redistributive Politics, and Economic Growth*, 3 J. ECON. GROWTH 217, 233 (1998); Roberto Perotti, *Political Equilibrium, Income Distribution, and Growth*, 60 REV. ECON. STUD. 755, 771–72 (1993).

(1) gross domestic product, and (2) per capita income. The second proposition is that the bountiful growth the advocates of supply-side tax policy envision will be shared by all. Their belief is that "a rising tide lifts all boats," which is a phrase borrowed from a speech by President John F. Kennedy over forty years ago.<sup>428</sup> As we have seen, the first proposition is highly doubtful and, in any event, is a false shibboleth, while the second proposition is clearly wrong.

The theory that the tax system should promote growth, that is, improve Kaldor-Hicks efficiency,<sup>429</sup> as measured by the GDP,<sup>430</sup> rests on the judgment that aggregate wealth maximization is a desirable public policy.<sup>431</sup> Economic growth as a goal for its own sake is based on modern welfare economics, which focuses largely on aggregate wealth maximization, which treats all dollars as having equal utility,<sup>432</sup> regardless of who receives those dollars.<sup>433</sup> The problem with this judgment is that an efficient market, evidenced by a large GDP, can result in extreme poverty for many and extraordinary wealth for a few.<sup>434</sup> Furthermore, a move, such as a change in the tax laws, is Kaldor-Hicks efficient anytime the winners gain more than the losers lose.<sup>435</sup> Thus, from this

<sup>428</sup> John F. Kennedy, Remarks in Pueblo, Colorado, PUB. PAPERS 626 (Aug. 17, 1962).

<sup>429</sup> Jules L. Coleman provides a concise definition of Kaldor-Hicks efficiency:

One state of affairs (E') is Kaldor-Hicks efficient to another (E) if and only if those whose welfare increases in the move from E to E' could fully compensate those whose welfare diminishes with a net gain in welfare. Under Kaldor-Hicks, compensation to losers is not in fact paid.

JULES L. COLEMAN, *MARKETS, MORALS, AND THE LAW* 98 (1988).

<sup>430</sup> GDP is the measure of all production inside the United States regardless of the nationality of the owner of the enterprise engaging in the manufacturing or production. CASE & FAIR, *supra* note 339, at 1002.

<sup>431</sup> If all dollars were of equal utility, regardless of how distributed, and interpersonal comparisons of utility were eschewed, a tax structure that maximizes (GDP) is by definition Kaldor-Hicks efficient, and no other tax structure is Kaldor-Hicks efficient. See John B. Shoven & Paul Taubman, *Saving, Capital Income, and Taxation*, in THE ECONOMICS OF TAXATION 203, 204 (Henry J. Aaron & Michael J. Boskin eds., 1980). Another measure of efficiency uses the Pareto criteria. A system is Pareto optimal when no Pareto efficient change is possible; a change is Pareto efficient if it can make one member of society better off, without making another member of the society worse off. CASE & FAIR, *supra* note 339, at 289. For a discussion of why Kaldor-Hicks efficiency is the touchstone for analysis, see Gary Lawson, *Efficiency and Individualism*, 42 DUKE L.J. 53, 88-96 (1992).

<sup>432</sup> See DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 153-54 (1986).

<sup>433</sup> See generally Robert Cooter & Peter Rappaport, *Were the Ordinalists Wrong About Welfare Economics*, 22 J. ECON. LITERATURE 507 (1984).

<sup>434</sup> AMARTYA SEN, *ON ETHICS AND ECONOMICS* 32-33 (1987).

<sup>435</sup> See Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211, 1221-22 (1991). Contrast to Pareto optimality, another measure of efficiency: a state is Pareto optimal if no Pareto superior moves are available. A Pareto superior move is a

perspective, increased efficiency, meaning economic growth, is viewed as a positive even if it results in redistribution from the poor to the rich, as long as the rich also get something more to boot.

The effect on per capita income is likewise a poor measure by which to compare alternatives. Focusing on per capita income is closely related to focusing on growth of Kaldor-Hicks efficiency, and both are errors. Per capita income is simply the average income of everyone. If the income of the richest person in the country increases and everyone else's income falls, as long as the income of the rich person increased by more than everyone else's income fell, per capita income would increase. It is difficult to envisage an open democratic government making a transparent policy decision that would have such an effect. Thus, it is clear that the maximization of either GDP or per capita income alone is not an adequate basis for determining the structure of the tax system, even if our only concern is the economic welfare of the citizenry. Again, distribution counts.<sup>436</sup>

That brings us to the rising tide. Does economic growth automatically result in increased income for all? Barely! Most estimates of the distribution of growth of per capita income in the last part of the twentieth century conclude that the poor saw some small increase in their incomes alongside the soaring incomes of the rich. The extraordinary surge in salaries of the top 1% "since the early 1970s has been accompanied with a dismal growth for the bottom 99% [of] salary earners, and thus does not seem to have had a positive impact on the vast majority of working families."<sup>437</sup> According to another study,

[t]he top 20% of families amassed 62% of total income growth between 1973 and 2000—with more than half going to the top 5 percent—while the bottom 20% accrued only 2% of total income growth; the second lowest quintile accrued only 5%. The pie grew larger, but hardly any of the increase went to those at the bottom.<sup>438</sup>

Within more discreet, but yet lengthy periods, we find examples of significant increases in GDP and per capita income that are accompanied by decreasing real incomes for large segments of the

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move that increases one person's welfare without decreasing anyone else's welfare. Welfare may be measured in terms of either utility or money. *See id.*; *see also* COLEMAN, *supra* note 429, at 100–03, 106–08.

<sup>436</sup> *See generally* Sen, *supra* note 325.

<sup>437</sup> SAEZ, *supra* note 349, at 32.

<sup>438</sup> KRUEGER, *supra* note 425, at 3.

population. For example, according to analysis of CBO data by Paul Krugman, from 1977 through 1989, the bottom 40% of the income distribution experienced decreasing real incomes, while everyone else below the top 1% saw modest increases in real incomes and the top 1% more than doubled its real income.<sup>439</sup> Professor Krugman estimates that 70% of the aggregate increase in average family income in this period accrued to the top 1% of families.<sup>440</sup>

Other recent work finds even more dramatic evidence that the economy is tilting in the reverse Robin Hood direction even as GDP and per capita income rise. Thomas Petska and Michael Strudler have found that constant dollar incomes for the bottom 60% of the income distribution fell rather steadily from 1979 through 1995, a long period of growth dotted with a few recessions, before beginning to rebound in the late 1990s, but by 2000 constant dollars income had not yet reached 1979 levels.<sup>441</sup> Yet another analysis, by Alan B. Krueger, paints an even worse picture, interpreting data for the period from 1973 to 1998 to indicate that although the overall average income grew, the average fell for everyone below the top 1%.<sup>442</sup> That estimate might be overly pessimistic, but the data from the CBO and Census Bureau both indicate that those in the lower half of the income spectrum experienced extraordinarily small increases in real income in a number of different time periods in which average household income grew substantially.<sup>443</sup> For example, the CBO data show that from 1982 to 1986, a period during which average household pre-tax income (in constant dollars) increased by \$4100 (a 16.07% increase), the average

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<sup>439</sup> Paul Krugman, *The Right, the Rich, and the Facts: Deconstructing the Income Distribution Debate*, 3 AM. PROSPECT 19, 21 (1992).

Increases in Household Income, 1977-1989	
Quintile	Percent Change
Lowest	-10%
2d	-2%
3d	+5%
4th	+10%
81 to 90%	+14%
91 to 95%	+18%
96 to 99%	+24%
Top 1%	+104%

<sup>440</sup> *Id.* at 23.

<sup>441</sup> See generally Petska et al., *supra* note 9.

<sup>442</sup> KRUEGER, *supra* note 425, at 3.

<sup>443</sup> See CONG. BUDGET OFFICE, *supra* note 23, at 30-31 tbl.B1-C; JONES & WEINBERG, *supra* note 21, at 5 tbl.3.

household income of the bottom quintile increased by a mere \$100 (a 0.8% increase), while the average household income of the second quintile increased by \$700 (a 5.05% increase). Likewise, from 1991 to 2000, a period during which average household pre-tax income (in constant dollars) increased by \$16,800 (a 29.32% increase), the average household income of the bottom quintile increased by only \$1100 (a 8.15% increase), while the average household income of the second quintile increased by \$3900 (a 13.27% increase).<sup>444</sup> Furthermore, from 1999 to 2000, when average household income increased by \$1100, average household income for the bottom three quintiles actually decreased. Consistently, the historical data from the 1980s and early 1990s reveal that poverty rates were unresponsive to economic expansion.<sup>445</sup> More recently, as the economy, measured by GDP, expanded in 2002, the poverty rate rose.<sup>446</sup>

The Census Bureau data for recent years are even more striking.<sup>447</sup> They show that mean household income (in constant dollars) for the first four quintiles declined fairly steadily from 1999 to 2001, while household income for the top quintile increased. Within that quintile, gains were concentrated at the top. While the mean income of the top quintile increased by 1.49%, the mean income of the top 5% (the smallest cohort measured by the Census Bureau) increased by 4.17%. Furthermore, the Census Bureau data understate the differences, because they do not include capital gains, which are highly concentrated in the top 5%, in its measure of income.

Although the details of the interpretation of the data may differ slightly, the big picture is unambiguous. The tide rises quite differently for the rich and the poor. Trickle-down might work to some extent, and the tide might rise a bit for everyone. But for those at the bottom, the flow of the tide is barely perceptible, and the tide is often ebbing for them while it flows for the rich. Those at the bottom are being trickled on,<sup>448</sup> and the trickle is not really lifting their boats.

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<sup>444</sup> The Census Bureau data paint a somewhat more rosy scenario. See generally U.S. CENSUS BUREAU, *supra* note 25.

<sup>445</sup> MISHEL & BERNSTEIN, *supra* note 317, at 253–96 (1994).

<sup>446</sup> Jared Bernstein & Jeff Chapman, Econ. Policy Inst., *Income Picture: Poverty Rises and Middle-Class Incomes Fall for Second Year Running* (Sept. 26, 2003), [http://www.epinet.org/content.cfm/webfeatures\\_econindicators\\_income20030926](http://www.epinet.org/content.cfm/webfeatures_econindicators_income20030926) (last visited Nov. 15, 2004).

<sup>447</sup> See generally U.S. CENSUS BUREAU, *supra* note 25.

<sup>448</sup> See Interview with Martin D. Ginsburg, in 12 ABA SECTION OF TAXATION NEWSLETTER (Section of Taxation, Am. Bar. Ass'n, Wash., D.C.), Fall 1992, at 6, 8. In an interview, Martin D. Ginsburg stated the following:



### C. The Budget Deficit Problem

Notwithstanding that the 2001 through 2003 tax cuts have contributed significantly to massive federal deficits,<sup>449</sup> their proponents claim that the tax cuts, and the resulting deficits will so stimulate the economy that the nation will “grow out of the deficit.”<sup>450</sup> That is highly unlikely.<sup>451</sup> Tax cuts increase output only if they increase personal saving by more than the revenue lost and the accumulating interest on national debt created by the tax cuts.<sup>452</sup> The CBO has acknowledged the problem with respect to the Bush tax cuts:

The revenue measures enacted since 2001 will boost labor supply by between 0.4 percent and 0.6 percent from 2004 to 2008 and up to 0.2 percent in 2009 to 2013 . . . .

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The argument for preferential treatment [of capital gains] is supposed to be that it encourages investment and therefore is good for the country. It was popular not too long ago to refer to the benefits “trickling down” until, I guess, people decided that they had been trickled on long enough, so new rhetoric is now being used . . . .

*Id.*

<sup>449</sup> For the ten-year deficit, see generally CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2005 TO 2014* (2004), available at <http://www.cbo.gov/ftpdocs/49xx/doc4985/01-26-BudgetOutlook-EntireReport.pdf> (last modified Apr. 6, 2004). For additional information, see Alice M. Rivlin & Isabel Sawhill, *Growing Deficits and Why They Matter*, in *RESTORING FISCAL SANITY: HOW TO BALANCE THE BUDGET*, *supra* note 411, at 15.

<sup>450</sup> Martin A. Sullivan, *Can Bush Repeat the Clinton Deficit-Reduction Miracle?*, 102 *TAX NOTES* 571, 573 (2004).

<sup>451</sup> Transcript, Concord Coalition et al., No End in Sight to Rising Deficits, Experts Warn, Policy Briefing at the Nat'l Press Club, Wash., D.C., at [http://www.concordcoalition.org/federal\\_budget/030929transcript.html](http://www.concordcoalition.org/federal_budget/030929transcript.html) (Sept. 29, 2003). In a joint statement, the Concord Coalition, the Center on Budget and Policy Priorities, and the Committee for Economic Development stated the following:

[I]nstead of expressing alarm, many in Washington now argue that escalating deficits do not really matter, that they are self-correcting, that they are unrelated to interest rates or future economic well-being, and that tax cuts will pay for themselves later by spurring economic growth. It would be wonderful if this were true. It is not.

Concord Coalition et al., *The Developing Crisis—Deficits Matter: Joint Statement* (Sept. 29, 2003), available at [http://www.concordcoalition.org/federal\\_budget/030929jointstatement.pdf](http://www.concordcoalition.org/federal_budget/030929jointstatement.pdf).

<sup>452</sup> Gravelle, *supra* note 114, at 655. See generally RICHARD KOGAN, *CTR. ON BUDGET AND POLICY PRIORITIES, WILL THE TAX CUTS ULTIMATELY PAY FOR THEMSELVES?* (Mar. 3, 2003) (stating that tax cuts do not stimulate economy enough to make up for lost revenues), available at <http://www.cbpp.org/3-3-03tax.pdf>.

But the tax legislation will probably have a negative effect on saving, investment, and capital accumulation over the next 10 years. . . .

The tax laws' net effect on potential output . . . will probably be negative in the second five years.<sup>453</sup>

Joel Slemrod has noted the following:

To the extent that the tax-cut-as-Trojan-Horse-for-spending cuts tactic is not successful, tax cuts result in bigger deficits. . . . [I]f there is little change in the path of planned spending, a tax cut now must then imply tax increases later. This inescapable "pay-me-now-or-pay-me-later" logic undercuts one common argument for a tax cut: that it will increase incentives to work, save, invest, and innovate. This is just loose language unless other aspects of the fiscal policy are specified. If lower taxes now imply there will be higher taxes later, then any increase in incentives now will be offset, and probably outweighed, by an increase in disincentives later—when the tax increases materialize.<sup>454</sup>

More recent projections by the CBO indicate that the situation will be worsened if the tax cuts are made permanent as requested by President Bush:

[I]f all of the tax provisions that are set to expire over the next 10 years (except some related to the alternative minimum tax) were extended, the budget outlook for 2014 would change from a surplus of \$13 billion to a deficit of \$443 billion. Debt held by the public at the end of that year would climb to 48 percent of GDP, and the 10-year deficit would total \$4.1 trillion.<sup>455</sup>

Even before the tax increases envisaged by Professor Slemrod come to pass, however, these budget deficits will present major problems to the economy. Over the long run they will result in diminished economic growth and a lower standard of living. One recent study by former Treasury Secretary Robert E. Rubin, Peter R. Orszag, and Allen Sinai concluded the following:

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<sup>453</sup> CONG. BUDGET OFFICE, *supra* note 278, at 45.

<sup>454</sup> Slemrod, *supra* note 349, at 619.

<sup>455</sup> See generally CONG. BUDGET OFFICE, *supra* note 449.

In the absence of significant policy changes, federal government deficits are expected to total around \$5 trillion over the next decade. Such deficits will cause U.S. government debt, relative to GDP, to rise significantly. Thereafter, as the baby boomers increasingly reach retirement age and claim Social Security and Medicare benefits, government deficits and debt are likely to grow even more sharply. The scale of the nation's projected budgetary imbalances is now so large that the risk of severe adverse consequences must be taken very seriously, although it is impossible to predict when such consequences may occur.

. . . [S]ustained budget deficits demonstrate the negative effects of deficits on long-term economic growth. Under the conventional view, ongoing budget deficits decrease national saving, which reduces domestic investment and increases borrowing from abroad. . . . The reduction in domestic investment (which lowers productivity growth) and the increase in the current account deficit (which requires that more of the returns from the domestic capital stock accrue to foreigners) both reduce future national income, with the loss in income steadily growing over time.<sup>456</sup>

A recent Brookings Institution study concludes the following:

[A] conservative estimate is that a \$5.3 trillion accumulation of additional debt over the next ten years [2004 through 2014] would reduce national income by \$212 billion annually at the end of the period. This translates into about \$1,800 less annual income for the average household than they otherwise would have earned.<sup>457</sup>

All of this may come to pass before the tax increases that Professor Slemrod foresees are enacted. Although sound economics might dictate that today's tax cut is the precursor to tomorrow's tax increase, in the world of politics, there is an asymmetry. Tax cuts are far easier to enact than tax increases.<sup>458</sup> Thus, the untoward effects of the federal budget deficit likely will come home to roost long before any unto-

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<sup>456</sup> ROBERT E. RUBIN ET AL., SUSTAINED BUDGET DEFICITS: LONGER-RUN U.S. ECONOMIC PERFORMANCE AND THE RISK OF FINANCIAL AND FISCAL DISARRAY 1 (2004), available at <http://www.brook.edu/views/papers/orszag/20040105.pdf>.

<sup>457</sup> Rivlin & Sawhill, *supra* note 449, at 9.

<sup>458</sup> *Id.* at 14–15.

ward effects of the future tax increases. As economist Martin Sullivan has observed:

[E]ven the most wonderful economic scenario is not rosy enough to eliminate deficits under current Republican policies. And don't let Republicans tell you that tax cuts will trigger growth that will reduce the deficit. That *might* be true if Republicans paid for tax cuts the old fashioned way—by cutting spending. Like a good martini, deficit-financed tax cuts can be temporarily invigorating, but you are fooling yourself if that is your program for long term health.<sup>459</sup>

Of course, it is difficult, if not impossible, to predict precisely who among the American population will be the winners and who will be the losers when national income growth diminishes as a result of these deficits. But if past is prologue, the Matthew Effect will hold sway and the lower and middle classes will fare more than proportionally worse than those at the top of the income pyramid. Even as the personal income tax system became more progressive during the 1990s, there was little increase in the overall progressivity of the federal tax system, and after-tax income inequality increased at a rate only slightly below the rate at which before-tax income inequality increased. And if the deficit problem is addressed through spending cuts, the effects are bound to be anti-progressive. Spending tends to be more proportional than taxation, and thus tends to be more progressive.<sup>460</sup> Tax cuts for the wealthy offset by spending cuts on programs that benefit the population as a whole reflect a clearly conscious Matthew Effect public policy decision.

## VI. THE PHILOSOPHICAL ARGUMENTS

"Every tax system is an expression of a country's basic values—and its politics."<sup>461</sup> The socially desirable distribution of after-tax incomes is not an economic issue, it is a philosophical issue to be resolved in the political arena.<sup>462</sup> There are no principles of economic theory dictating the manner in which aggregate social product will or

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<sup>459</sup> Sullivan, *supra* note 450, at 573.

<sup>460</sup> See Steuerle, *supra* note 186, at 1187–88; WOLFF ET AL., *supra* note 326, at 10–11, 27 (arguing that mean amount of public consumption increases with each income decile, but public consumption as a percentage of income decreases as income decile increases).

<sup>461</sup> STIGLITZ, *supra* note 4, at 177.

<sup>462</sup> See 2 *Replacing the Federal Income Tax: Hearing Before House Comm. on Ways and Means*, 104th Cong., H.R. Doc. No. 104-46, at 123, 124 (1996) (statement of Alan J. Auerbach).

should be distributed. How the social product, or any increase in the social product will be distributed among taxpayers before-tax is an empirical issue, not a theoretical question. If we are at all consequentialist, because either a Kaldor-Hicks efficient or Pareto optimal state can exist even though many people are in extreme poverty and a very few are extraordinarily wealthy,<sup>463</sup> welfare economics really has very little to offer to use in the formulation of tax policy except to provide some baseline expectation regarding the pre-tax distribution of income as the background against which to construct a tax system that will produce the socially desired after-tax distribution of income.

Traditionally, progressive taxation has been justified either on the grounds of "ability to pay" or on the principle of the diminishing marginal utility of money. Those arguments have been thoroughly discussed elsewhere, so they will not be rehashed here.<sup>464</sup> The evidence of the diminishing marginal utility of money is more than adequate to support a graduated progressive rate structure, and one that is quite steeply progressive at the very top end.<sup>465</sup> The super-rich simply have so much money that their lifestyle is not currently,<sup>466</sup> and has not in the past few decades been, affected by taxation in any manner with which we as a society ought to be concerned, and it would not be significantly affected even if their marginal tax rates were significantly increased.

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<sup>463</sup> See SEN, *supra* note 434, at 32–33. A system is Pareto optimal when no Pareto efficient change is possible; a change is Pareto efficient if it can make one member of society better off, without making another member of the society worse off. CASE & FAIR, *supra* note 339, at 289. For a discussion of Kaldor-Hicks efficiency, see *supra* notes 429–436 and accompanying text. For a discussion of why Kaldor-Hicks efficiency is generally the touchstone for analysis rather than Pareto criteria, see Lawson, *supra* note 431, at 88–96.

<sup>464</sup> See Maureen B. Cavanaugh, *Democracy, Equality, and Taxes*, 54 ALA. L. REV. 415, 419–30 (2003); see also Blum & Kalven, *supra* note 109, at 417 (concluding that the evidence of the diminishing marginal utility of money is not strong enough to warrant progressive taxation). See generally Donna M. Byrne, *Progressive Taxation Revisited*, 37 ARIZ. L. REV. 739 (1995) (discussing the debate); Mark S. Stein, *Diminishing Marginal Utility of Income and Progressive Taxation: A Critique of The Uneasy Case*, 12 N. ILL. U. L. REV. 373 (1992) (discussing the debate).

<sup>465</sup> See McMahon & Abreu, *supra* note 46, at 32–39, 71–78.

<sup>466</sup> Witness, among other extravagances, Bill Gates' \$100 million mansion, the \$2 million birthday party that Malcolm Forbes threw for himself in Morocco in 1989, and consider Ross Perot and Steve Forbes's self-financed runs for the presidency. See generally Richard Folkers, *Xanadu 2.0, Bill Gates's Stately Pleasure Dome and Futuristic Home*, U.S. NEWS & WORLD REPORT, Dec. 1, 1997 at 87 (discussing Bill Gates); *It's Your Party*, NEW REPUBLIC, Sept. 11, 1989, at 4 (discussing Malcolm Forbes). Consider also the widely reported extravagances of Jack Welch, former CEO of General Electric, and Dennis Kozlowski, former CEO of Tyco, which although paid for out of corporate funds, were economic income—even if they might not have reported it on their tax returns.

Here I will add the further argument that progressive taxation easily can be justified purely on redistributive grounds to mitigate economic inequality and to further social justice. These are the very grounds that led Walter J. Blum & Harry Kalven Jr. in *The Uneasy Case for Progressive Taxation*<sup>467</sup> to be "uneasy" about progressive taxation.<sup>468</sup> Unlike Professors Blum and Calvin, I believe that society as a whole rightly has the paramount say in the distribution of incomes and wealth.

### A. *The Myth of Ownership*

"Taxes are what we pay for a civilized society"<sup>469</sup>—government, courts, police, national defense, schools, roads, and the like. Much of the philosophical opposition to taxes, particularly graduated progressive taxes on the rich, is based on the neoconservative philosophy, epitomized by Robert Nozick,<sup>470</sup> that individuals are morally entitled to keep the fruits of their labor and have a claim superior to the societal claim.<sup>471</sup> This argument flows from the Lockean position that the rights of the individual precede those of the state.<sup>472</sup> Similar arguments have been advanced by Milton Friedman<sup>473</sup> and Richard Epstein,<sup>474</sup> among others, to support flat-rate taxation rather than graduated progressive taxation.<sup>475</sup> These arguments have been thoroughly discussed elsewhere, and I will not review the details. They all are essentially grounded on a libertarian philosophy.<sup>476</sup> That libertarian claim is simply not supportable.

In a modern industrialized society everyone benefits from governmental infrastructure. Incomes are not earned solely by one's own efforts.<sup>477</sup> In addition to the head start most of the wealthy receive by

<sup>467</sup> See generally Blum & Kalven, *supra* note 109.

<sup>468</sup> See Cavanaugh, *supra* note 464, at 423.

<sup>469</sup> *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

<sup>470</sup> See generally ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* (1974).

<sup>471</sup> See Kornhauser, *The Rhetoric*, *supra* note 109, at 498–504 (explaining and criticizing Nozick's position); see also Byrne, *supra* note 464, at 782–86 (demonstrating that Nozick's theory logically disallows almost all taxation, not merely progressive taxation).

<sup>472</sup> See Kornhauser, *Fair Income Tax*, *supra* note 109, at 620–23.

<sup>473</sup> See MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 172–76 (1962).

<sup>474</sup> See generally RICHARD A. EPSTEIN, *TAKINGS* (1985); Richard A. Epstein, *Taxation in a Lockean World*, in *PHILOSOPHY AND LAW* 49 (Jules Coleman & Ellen Frankel Paul eds., 1987).

<sup>475</sup> See Fried, *supra* note 109, at 159–66, 172–75.

<sup>476</sup> See *id.* at 159–60.

<sup>477</sup> McMahon & Abreu, *supra* note 46, at 67–68.

being born into affluence,<sup>478</sup> which alone destroys the baseline for Professor Nozick's proceduralist argument that everyone starts out equally,<sup>479</sup> everyone's pre-tax income is earned in an infrastructure created by government.<sup>480</sup> Often the benefits conferred on the wealthy by government go beyond mere infrastructure and are subsidies that are in essence the seed money or even the life-blood of their enterprises. Patents, which are very important in building great wealth, often represent the privatization of public resources—ideas that were based largely on publicly funded research.<sup>481</sup> Another public resource, the telecommunications broadcast spectrum, has been made available free of charge to entrepreneurs, as well as to large corporations, and has been a source of great wealth. The bottom line is that "the baseline for determining the benefits of government is the welfare a person would enjoy if government were entirely absent; the benefit of government services must be understood as the difference between someone's level of welfare in a no-government world and their welfare with government in place."<sup>482</sup>

Some of the rich clearly acknowledge this state of affairs. Warren Buffett, who perennially appears as one of the five richest Americans in the *Forbes* 400 list, has said the following:

I personally think that society is responsible for a very significant percentage of what I've earned. If you stick me down in the middle of Bangladesh or Peru or someplace,

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<sup>478</sup> See generally William G. Gale & John Karl Scholz, *Intergenerational Transfers and the Accumulation of Wealth*, 8 J. ECON. PERSP., Fall 2004, at 145 (arguing that intergenerational transfers, primarily among the wealthy, account for over one-half of net worth, and the percentage is higher if payment of college tuition is counted). Consider, for example, that in 1995 and 1996, 43.35% of the individuals in *Forbes* 400 list or wealthiest Americans inherited enough to make the list. PAUL ELWOOD ET AL., UNITED FOR A FAIR ECONOMY, BORN ON THIRD BASE: THE SOURCES OF WEALTH OF THE 1996 FORBES 400, [http://www.ufenet.org/press/archive/Pre\\_1999/forbes\\_400\\_study.html](http://www.ufenet.org/press/archive/Pre_1999/forbes_400_study.html) (last visited Nov. 15, 2004). See generally CHUCK COLLINS ET AL., UNITED FOR A FAIR ECONOMY, I DIDN'T DO IT ALONE: SOCIETY'S CONTRIBUTION TO INDIVIDUAL WEALTH AND SUCCESS (2004) (detailing stories of wealthy Americans who recognize that other factors, such as societal investment, privilege, historical timing, and luck, had a role in their success), available at <http://www.responsible-wealth.org/press/2004/notalonereportfinal.pdf> (last modified Oct. 20, 2004).

<sup>479</sup> BRUCE A. ACKERMAN, *SOCIAL JUSTICE IN THE LIBERAL STATE* 221 (1980). David Cay Johnston provides a wonderful example of this in his recent book, *Perfectly Legal*, in which he points out that Bill Gates started Microsoft with a gift from his parents. See JOHNSTON, *supra* note 233, at 83.

<sup>480</sup> See generally MURPHY & NAGEL, *supra* note 323.

<sup>481</sup> STIGLITZ, *supra* note 4, at 208.

<sup>482</sup> MURPHY & NAGEL, *supra* note 323, at 16.

you'll find out how much this talent is going to produce in the wrong kind of soil.<sup>483</sup>

William H. Gates, Sr.—the father of one of the world's richest men and an outspoken opponent of estate tax repeal—has articulated the point as well:

Like the “great man” theory of history, our dominant “great man” theory of wealth creation borders on mythology. Such folklore fills the pages of business magazines. In a recent interview, one chief of a global corporation was asked to justify his enormous compensation package. He responded, “I created over \$300 billion in shareholder value last year, so I deserve to be greatly rewarded.” The operative word here is “I.” There was no mention of the share of wealth created by the company's other 180,000 employees. From this sort of thinking, it is a short distance to, “It's all mine” and, “Government has no business taking any part of it.”

There is no question that some people accumulate great wealth through hard work, intelligence, creativity, and sacrifice. Individuals do make a difference, and it is important to recognize individual achievement. Yet it is equally important to acknowledge the influence of other factors, such as luck, privilege, other people's efforts, and society's investment in the creation of individual wealth.

Consider the many components of the social framework that enable great wealth to be built in the United States. Among them are a patent system, enforceable contracts, open courts, property ownership records, protection against crime and external threats, and public education. Even the stock market is a form of socially created wealth that provides liquidity to enterprises. David Blitzer, the chief investment strategist at Standard and Poors, recently wrote, “Financial markets are as much a social contract as is democratic government.” When faith in this social system is

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<sup>483</sup> THEY SAID IT (comp. by Sam Pizzigati), at <http://www.inequality.org/quotes2.html> (last visited Nov. 15, 2004) (attributing quotation to Warren Buffett).



shaken, as it has been by recent breaches of trust, we see how quickly individual wealth evaporates.<sup>484</sup>

As this passage so clearly explains, the entire infrastructure of society, which is funded by taxes, is an absolute prerequisite to the ability to earn the munificent incomes realized by America's richest citizens. Liam Murphy and Thomas Nagel have elegantly expressed and expanded on these principles in *The Myth of Ownership*:

There is no market without government and no government without taxes; and what type of market there is depends on laws and policy decisions that the government must make. In the absence of a legal system supported by taxes, there couldn't be money, banks, corporations, stock exchanges, patents, or a modern market economy—none of the institutions that make possible the existence of almost all contemporary forms of income and wealth.<sup>485</sup>

This is a proposition with which no one reasonably can argue. Because this proposition is immutable, the starting point for Professor Nozick's philosophy—Hobbes' man in a state of nature—that leads him and others to find strict moral limits on society's right to levy taxes is so counterfactual that their entire argument vaporizes with no further criticism needed.

Alice Abreu and I have previously focused on this immutable truth to analogize taxes to "rent" in effect charged by society for the privilege of participating in the market. That rent is in turn plowed back into maintaining that market in the form of public goods.<sup>486</sup> We argue the following:

[N]o individual has a right to any particular [rental] "price," that is, tax rate, for the use of public goods, just like no individual has a right to buy an automobile at the lowest price at which the dealer has sold it to another individual. Everybody must pay the price that the market will bear. Thus there is no

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<sup>484</sup> William H. Gates Sr. & Chuck Collins, *Tax the Wealthy: Why America Needs the Estate Tax*, 17 AM. PROSPECT, June 17, 2002, at 20, 21, available at <http://www.prospect.org/print-friendly/print/V13/11/gates-w.html> (last visited Nov. 15, 2004).

<sup>485</sup> MURPHY & NAGEL, *supra* note 323, at 33–34; see ACKERMAN, *supra* note 479, at 53–59 (arguing that individuals have no natural right to keep the fruits of extraordinary beneficial endowments); James Tobin, *Considerations Regarding Taxation and Inequality*, in INCOME REDISTRIBUTION 127, 131–32 (Colin D. Campbell ed., 1976).

<sup>486</sup> McMahon & Abreu, *supra* note 46, at 68–70.

need to justify progressive taxation as redistributive. It is no more redistributive than the difference in price between a Cadillac and a Ford Escort. The purchaser of a luxury car, who exercises a claim on a greater share of resources than does the purchaser of a modest car, must pay more—however much more the seller wants to charge. If the buyer doesn't like the price of the Cadillac, she can purchase the Escort. A high income earner, like a low income earner, must pay more for the use of those public goods—however much more the seller, the citizenry acting through its government, wants to charge. If she doesn't like the price, she can choose a lower income level.<sup>487</sup>

Professors Murphy and Nagel make a similar point when they treat taxes as “essentially modifications of property rights.”<sup>488</sup> Because property rights are derived from society, acting through government, taxes cannot be evaluated as a modification of a “just” pre-tax income.<sup>489</sup>

In debunking theories of “benefits” taxation, Professors Murphy and Nagel go on to make an even more important point. They point out that without government,

there is little doubt that everyone's level of welfare would be low—and importantly—roughly equal. We cannot pretend that the differences in ability, personality, and inherited wealth that lead to great inequalities of welfare in an orderly market economy would have the same effect if there were no government to create and protect legal property rights and their value and to facilitate mutually beneficial exchanges.<sup>490</sup>

That stark, realistic and hardly debatable proposition leads to the conclusion that the “fairness” of taxes is not a function of their effect on pre-tax income:

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<sup>487</sup> *Id.* at 69–70.

<sup>488</sup> MURPHY & NAGEL, *supra* note 323, at 44.

<sup>489</sup> *Id.* at 31–37. Even though from a philosophical viewpoint, this argument can be carried to the point of supporting confiscatory taxation of very high incomes, I will not argue for complete confiscation of extraordinarily high incomes. I suppose that an express 100% marginal rate might be considered unconstitutional. *But see* Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 84–85 (1990) (arguing that on the basis of dictum in U.S. Supreme Court cases it would not be unconstitutional to tax away inheritances through confiscatory taxation).

<sup>490</sup> MURPHY & NAGEL, *supra* note 323, at 16–17.

It is therefore logically impossible that people should have any kind of entitlement to their pre-tax income. All they can be entitled to is what they would be left with after taxes under a legitimate system, supported by legitimate taxation—and this shows that we cannot evaluate the legitimacy of taxes by reference to pretax income. Instead we have to evaluate the legitimacy of after-tax income by reference to the legitimacy of the political and economic system that generates it, including the taxes that are a legitimate part of that system. The logical order of priority between taxes and property rights is the reverse of that assumed by libertarianism.<sup>491</sup>

This analysis reflects a consequentialist viewpoint of distributive justice, a view with which I agree.

For a variety of reasons, wholly apart from the preceding argument, it should be obvious that pre-tax income is in no way “deserved.” To start with, many large incomes are derived from inherited wealth.<sup>492</sup> These rich, high-income earners did nothing to earn their wealth or their income.<sup>493</sup> Both are an accident of birth. Even at incomes below these rarified levels, there is a significant correlation between parents’ and children’s lifetime incomes.<sup>494</sup> Thus, the “lucky gene pool” club is a significant determinant of incomes even apart from large inheritances.

Even among those who have risen to wealth or high incomes from more modest means, there is no valid basis for concluding that they “deserve” that income more than many other individuals who have not achieved anywhere near such a high income level. First, as so clearly demonstrated by Robert H. Frank and Phillip J. Cook in *The Winner-Take-All Society*,<sup>495</sup> labor markets increasingly operate in ways

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<sup>491</sup> *Id.* at 32–33.

<sup>492</sup> See Gale & Scholz, *supra* note 478, at 8; see also PHILLIPS, *supra* note 49, at 108–27.

<sup>493</sup> For a proposal to deal with this problem through near confiscatory taxation of inheritances, see Ascher, *supra* note 489, at 69. I am not raising the issue in the text for the purpose of endorsing confiscatory taxation of inheritances, but merely for the purpose of demonstrating that large incomes often are more attributable to luck than to anything else and that there thus is no “unfairness” in applying high graduated progressive tax rates (even as high as 90%) to very high incomes (or wealth transfers).

<sup>494</sup> Gary Solon, *Intergenerational Income Mobility in the United States*, 82 AM. ECON. REV. 393, 403–04 (1992); David J. Zimmerman, *Regression Toward Mediocrity in Economic Stature*, 82 AM. ECON. REV. 409, 427 (1992).

<sup>495</sup> See generally FRANK & COOK, *supra* note 44. For earlier work of a similar tenor, see generally DEREK BOK, *THE COST OF TALENT* (1993); Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981); Sherwin Rosen, *Prizes and Incentives in Elimination Tournaments*, 76 AM. ECON. REV. 701 (1986).

that provide rewards vastly disproportionate to differences in effort and ability. In these “winner-take-all-markets,” a large number of individuals compete for a relatively small number of positions that offer the possibility for financial rewards that far exceed those that await less successful competitors. Although this type of labor market might have originated in entertainment and athletics, in recent years this model describes the market for doctors, lawyers, corporate management, and investment bankers, among others at the top of the income pyramid.<sup>496</sup> Even though in most, if not in all, cases it took hard work to get to the top, there was a lot of luck involved—being born intelligent, having become the protégé of a well-connected mentor, or simply being in the right place at the right time—and others who worked just as hard simply did not have such good luck.

Furthermore, the very high incomes of some top-income earners might be attributable to luck that was “made” in a manner that reflects anything but deservedness. For example, during the 1990s most of the astronomical pay of the CEOs of publicly traded corporations was attributable to stock option transactions. Much of the increase in the value of their stock options was attributable to a general rise in the stock market, not to anything that they did to increase the value of their corporation’s stock. Moreover, in many instances when the value of the corporation’s stock fell to below the strike price of the option, the options were rewritten to better assure the executives a chance to make a profit on the options. On top of that, the nature of the transactions generally was hidden from shareholders. That these individuals could extract wealth from the shareholders of the corporations on such a scale was the result of a market failure, not the result of well-functioning markets.<sup>497</sup> Again we see, through an example, that before-tax income is not necessarily “deserved” in any moral sense.

Finally, we must take into account the scale on which the federal government acts to preserve the wealth of the rich when their own economic actions threaten the preservation of that wealth. Persistent government bailouts have effectively eliminated “moral hazard” from investment decisions. These bailouts, which preserve the wealth of shareholders of corporations and other financial speculators range from saving a single corporation, such as automobile manufacturer

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<sup>496</sup> McMahon & Abreu, *supra* note 46, at 25 & n.86. For a demographic profile of high income earners, see generally Wolff, *supra* note 47.

<sup>497</sup> STIGLITZ, *supra* note 4, at 120–26.

Chrysler, from bankruptcy—although Chrysler was hardly the only such individual manufacturing corporation assisted by the government—to industry wide bailouts, such as the bailout of the savings and loan industry in the late 1980s and early 1990s. The list is a long one.<sup>498</sup>

All of this leads to the inevitable conclusion that it is the after-tax distribution of income that counts the most. Because there is nothing “fair” or even efficient about the before-tax distribution of income, it is pointless to discuss the fairness of tax rates or the relationship of before-tax income to after-tax income in the abstract. Before-tax income is relevant only insofar as it is the benchmark for society to use in determining the tax structure necessary to reach the desired distribution of after-tax income. A vastly disproportionate distribution of before-tax incomes in and of itself can justify highly progressive income taxation for no other reason than doing so will achieve the societally desired distribution of after-tax incomes, as much as for the reason that progressive taxation is fair because it is the only system that takes into account the diminishing marginal utility of money. It is as valid to levy taxes that equalize income as it is to levy proportional taxes. I will not go so far as to say that it is equally valid to level a head tax, as some have suggested is the only valid tax.<sup>499</sup> Reliance solely on capitation taxes can have such a deleterious effect on the welfare of the worst off in society that it must be rejected,<sup>500</sup> as even the proponents of “flat taxes” acknowledge when they consistently propose generous exclusions.<sup>501</sup> Subject to this limitation—that we must avoid doing great harm to those who have the least—there is no reason for society not to adopt a tax structure that results in the greatest good for the greatest number of citizens. This does not require absolute equality, despite the implications of such an end if the concept of the diminishing marginal utility is followed to its logical conclusion. The level of taxes and transfer payments necessary to achieve that end—taxes and government expenditures at levels heretofore inconceivable—would be bound to have disincentive effects that historical levels of taxation never have produced. But there is good reason to tax

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<sup>498</sup> PHILLIPS, *supra* note 49, at 103–07.

<sup>499</sup> See generally, e.g., Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL’Y 221 (1995).

<sup>500</sup> See MURPHY & NAGEL, *supra* note 323, at 140–41; see also SLEMRD & BAKIJA, *supra* note 174, at 47–48 (discussing riots in London after the Thatcher government replaced property taxes with capitation taxes in 1990). See generally RAWLS, *supra* note 348.

<sup>501</sup> See, e.g., ROBERT HALL & ALVIN RABUSHKA, *THE FLAT TAX*, 53–54 (2d ed. 1995). See generally Charles R. O’Kelley, Jr., *Tax Policy for Post-Liberal Society: A Flat-Tax-Inspired Redefinition of the Purpose and Ideal Structure of a Progressive Income Tax*, 58 S. CAL. L. REV. 727 (1985).

the very rich heavily—much more heavily than we do now—to provide for the very poor and to provide greater government infrastructure, particularly universal healthcare and high quality education, for everyone,<sup>502</sup> even if it diminishes the welfare of the rich by more than it improves the welfare of everyone else.<sup>503</sup>

### B. *The Danger of Concentration of Political Power in the Wealthy*

Concentration of wealth and income in a very small segment of society will lead to an undesirable concentration of political power.<sup>504</sup> This notion is as old as our nation.<sup>505</sup> Although many of the Founders believed in a “natural aristocracy,” membership in which depended partly on wealth, and which would have a major role in government, they also were concerned with excessive wealth inequality.<sup>506</sup> Thus, any debate over the most desirable rate structure must take into account the effect of the distribution of income and wealth on political outcomes generally.<sup>507</sup>

Concentrations of wealth provide a greater voice to the wealthy in the political process.<sup>508</sup> In the 2000 federal elections, nearly one-

<sup>502</sup> See Lee & Roemer, *supra* note 427, at 233 (indicating that although taxes theoretically can reduce private investment, they also fund public investment in activities, such as education, that increase productivity).

<sup>503</sup> See MURPHY & NAGEL, *supra* note 323, at 140–41.

<sup>504</sup> See KEVIN PHILLIPS, ARROGANT CAPITAL 206–10 (1994); RAWLS, *supra* note 348, at 277–78; STIGLITZ, *supra* note 4, at 301–02. See generally REUVEN S. AVI-YONAH, CORPORATIONS, SOCIETY AND THE STATE: A DEFENSE OF THE CORPORATE TAX (Univ. of Mich. Law, Olin Ctr. for Law & Econ., Working Paper No. 04-006, 2004) (defending the corporate income tax as a curb on the excessive concentration of wealth in corporations and resulting concentration of power in corporate management), available at <http://www.law.umich.edu/centersandprograms/olin/abstracts/discussionpapers/2004/avi-yonah04-006.pdf>.

<sup>505</sup> See LANCE BANNING, THE SACRED FIRE OF LIBERTY: JAMES MADISON & THE FOUNDING OF THE REPUBLIC 39–42 (1995) (discussing the belief that great extremes of wealth and poverty were incompatible with freedom in eighteenth century Britain, and its influence on the Founders); Marjorie E. Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119, 124–28 (1994) (discussing competing theories of equality fueling the American revolution).

<sup>506</sup> See Cavanaugh, *supra* note 464, at 441–42.

<sup>507</sup> See Harold M. Groves, *Toward a Social Theory of Progressive Taxation*, 9 NAT'L TAX J. 27, 29 (1956).

<sup>508</sup> Stephen Ansolabehere & James M. Snyder, Jr., *Money and Institutional Power*, 77 TEX. L. REV. 1673, 1676–77 (1999); Repetti, *supra* note 105, at 840–49. Furthermore, there is reason to believe that income inequality increases corruption. The rich may have greater motivation and opportunity to engage in bribery and fraud as one means to preserve and advance their status. Conversely, the poor are more vulnerable to extortion at higher levels of inequality. This is true in democracies as well as in authoritarian regimes. In a democracy, the rich will increasingly resort to corruption as inequality and subsequent voter demands for redistribution increase to offset the median voter demands on the government. See JONG-

third of combined contributions to the political parties could be traced to "large individual donors."<sup>509</sup> One-sixth of contributions consisted of "soft money" and nearly 10% was PAC money, much of which might be traceable to the rich. Over one-half of contributions came from contributions of \$10,000 or more, and 15% came from contributions of \$100,000 or more.<sup>510</sup> Nearly 50% of donors to congressional campaigns had a family income of \$250,000 or more, and 20% had a family income of \$500,000 or more.<sup>511</sup>

Large contributions influence elected officials in a number of subtle and not so subtle ways beyond "vote buying." Contributions "help shape the context of legislation, the candidates who run for office, and the agendas on which parties campaign," and help provide access.<sup>512</sup> Because one of the principal determinants of winning an election is financial resources,<sup>513</sup> the candidate who garners the most contributions most often garners the most votes.<sup>514</sup> Thus, the wealthy, who generally make the most political contributions, enjoy a disproportionate say in who gets elected. This disproportionate say is not limited to the general election, but applies to primaries as well. Thus, in the general election, candidates of both parties are beholden to donors from the upper class. Although there are legal limitations on amounts that can be donated, they have not been particularly effective.<sup>515</sup>

The influence of money does not necessarily end with the election. There is evidence that contributions influence the actions of leg-

SUNG YOU & SANJEEV KHAGRAM, *INEQUALITY AND CORRUPTION* (Hauster Ctr. for Nonprofit Org., Working Paper No. 22, 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=489823](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=489823) (dated posted Jan. 21, 2004).

<sup>509</sup> PHILLIPS, *supra* note 49, at 324 chart 8.1.

<sup>510</sup> *Id.* at 328.

<sup>511</sup> *Id.*

<sup>512</sup> See Paul Frymer & Albert Yoon, *Political Parties, Representation, and Federal Safeguards*, 96 NW. U. L. REV. 977, 1015 (2002).

<sup>513</sup> See, e.g., ANTHONY GIERZYNSKI, *MONEY RULES: FINANCING ELECTIONS IN AMERICA* 11-12 (2000). See generally Alan I. Abramowitz, *Explaining Senate Election Outcomes*, 82 AM. POL. SCI. REV. 385 (1988). The other major factor is incumbency. See generally Stephen Ansolabehere & James M. Snyder, Jr., *The Incumbency Advantage in U.S. Elections: An Analysis of State and Federal Offices, 1942-2000*, 1 ELECTION L.J. 315 (2002). Money also influences elections by allowing political parties to organize get out the vote drives. Stephen Ansolabehere & James M. Snyder, Jr., *Soft Money, Hard Money, Strong Parties*, 100 COLUM. L. REV. 598, 617 (2000).

<sup>514</sup> See Repetti, *supra* note 105, at 845-46. See generally Donald P. Green & Jonathan S. Krasno, *Salvation for the Spendthrift Incumbent: Reestimating the Effects of Campaign Spending on House Elections*, 32 AM. J. POL. SCI. 884 (1988).

<sup>515</sup> See Repetti, *supra* note 105, at 843-45; Daniel L. Simmons, *An Essay on Federal Income Taxation and Campaign Finance Reform*, 54 FLA. L. REV. 1, 12-26 (2002).

islators and other elected officials, although there is not strong evidence that floor votes are directly influenced.<sup>516</sup> But only proposals approved in committee get to a floor vote, and there is stronger evidence that contributions affect actions of legislators in committees.<sup>517</sup> Likewise, presidential proposals might be influenced. Some would suggest that we need look no further than President Bush's environmental and energy policies to support this thesis.<sup>518</sup>

Wholly apart from the obvious anti-democratic philosophical problems of wealth purchasing influence in the public policy arena, the disproportionate voice of the wealthy in politics also may be economically inefficient. For example, "[w]hen inequality is high, the wealthy are more likely to block *efficiency enhancing* programs that would improve educational opportunities for the less well off."<sup>519</sup> Education increases human capital and fosters equal opportunity to prosper. To the extent concentration of wealth works to reduce the amount of aggregate societal resources that will be devoted to education, it inhibits economic growth as well.

Thus, to the extent highly progressive income taxes (and estate taxes) on those at the very top of the income pyramid help to mitigate concentrations of wealth and consequent political power, those taxes help to preserve liberty, freedom, and opportunity for the greatest number of citizens.<sup>520</sup> Of course, there are limits to the ability to limit the economic power of the rich over politics through a progressive income tax,<sup>521</sup> but that does not mean we should not try. Furthermore, the income tax need not be the only tool applied to solve this problem. A preserved and strengthened estate tax should aid in attempting to achieve this goal. Another more radical proposal would be to impose an excise tax on political contributions, or simply make them subject to the gift tax with only a very small annual exclusion—a few hundred dollars at most—and no lifetime exemption.

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<sup>516</sup> See Ansolabehere & Snyder, *supra* note 508, at 1690–93; Repetti, *supra* note 105, at 848–49. But see Stacy B. Gordon, *All Votes Are Not Created Equal: Campaign Contributions and Critical Votes*, 63 J. POL. 249, 260–61 (2001) (finding a relationship between campaign contributions and votes in close roll call votes).

<sup>517</sup> See Repetti, *supra* note 105, at 848. See generally Diana Evans, *Before the Roll Call: Interest Group Lobbying and Public Outcomes in House Committees*, 49 POL. RES. Q. 287 (1996).

<sup>518</sup> See KRUEGER, *supra* note 425, at 8.

<sup>519</sup> *Id.* at 8–9.

<sup>520</sup> See RAWLS, *supra* note 348, at 277–79. See generally PHILLIPS, *supra* note 504.

<sup>521</sup> See WITTE, *supra* note 109, at 373–77 (discussing the limits of the ability of a progressive income tax to effect redistribution).



## VII. THE PARADOX OF VOTER ACQUIESCENCE

This brings us to the question of why the typical voter tolerates growing economic inequality and a parade of tax legislation that not only is doing nothing to mitigate that growing inequality, but instead is systematically working to increase that inequality. Some economists express concern that large disparities of wealth cause socio-political instability; their concern is that such instability impedes economic growth.<sup>522</sup> In the United Kingdom, when the Margaret Thatcher government attempted to replace a property tax with a capitation tax in 1990, the result was riots in the streets of London. The change would have been very regressive. The public outcry is credited with leading to the replacement of Margaret Thatcher by John Major as prime minister.<sup>523</sup>

One of the studies of the relationship of economic inequality, socio-political instability, and economic growth concluded that the United States has one of the marginally higher indices of social-political instability among major industrialized democracies.<sup>524</sup> If that is true, it does not appear that the instability is manifesting itself in demands for more redistributive taxation. The question is, why not?

One possible explanation is that Americans do not care about inequality, that their focus is on the "American dream." That explanation has been offered by journalist Robert J. Samuelson, who believes Americans focus on their own ability to get ahead rather than on existing inequality.<sup>525</sup> Nathan Glazer similarly has argued that "most Americans remain apathetic about inequality: What we have today is outrage against those who do not play fair—not outrage over inequality as such."<sup>526</sup> Professor Glazer goes on to observe the following:

[T]his is surprising. After all, the United States is the most unequal of the economically developed countries—and that inequality has been increasing. If Americans don't care about inequality, it obviously isn't because inequality doesn't exist here.

One could argue that they don't care about inequality because the poor do pretty well in America . . . .<sup>527</sup>

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<sup>522</sup> Perotti, *supra* note 420, at 173–77; see Repetti, *supra* note 105, at 840.

<sup>523</sup> See SLEMROD & BAKIJA, *supra* note 174, at 47–48.

<sup>524</sup> Alesina & Perotti, *supra* note 424, at 1211.

<sup>525</sup> Robert J. Samuelson, *Indifferent to Inequality?*, 137 NEWSWEEK, May 7, 2001, at 45, 45.

<sup>526</sup> Nathan Glazer, *On Americans and Inequality*, 132 DAEDALUS, Summer 2003, at 111,

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<sup>527</sup> *Id.*

Professor Glazer appears to conclude that Americans conclude that inequality does not matter because the poor are well off.

That the poor in America are better off than the poor elsewhere in the industrialized world is a misconception. It is true that until recently the United States was so much richer than other countries that even the poor lived better here than anywhere else, but that is no longer true. America's poor are still better off than many, in some cases most, of the population of Third World countries, but a better point of comparison is the industrialized democracies of Western Europe. Based on real purchasing power, the poor (measured at the tenth percentile) are better off than the poor in the United Kingdom and Australia, but are marginally worse off than the poor in Sweden, Canada, and Finland, and substantially worse off than the poor in the Netherlands, Germany, Belgium, France, Switzerland, Denmark, and Norway.<sup>528</sup> Reflecting our inequality, at the ninetieth percentile Americans had the highest standard of living. But perception rather than reality is more important in shaping voter attitudes. Do Americans recognize the growing economic inequality?

Americans generally do seem to understand that inequality is increasing, and they generally are not pleased by it. Although Americans are tolerant of some amount of inequality as long as it results from equal opportunity and merit, they generally believe that there should be less inequality than currently exists, recognizing that needs as well as merit should be taken into account in the distribution of wealth.<sup>529</sup> In a 2002 National Election Study Survey,<sup>530</sup> nearly 75% of respondents said that the difference in incomes between rich people and poor people was larger than twenty years ago; more than 40% recognized that it was much larger; and only about 8% thought inequality had decreased.<sup>531</sup> "[A] majority of those who recognized that

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<sup>528</sup> See generally Christopher Jencks, *Does Inequality Matter?*, 131 DAEDALUS, Winter 2002, at 49; TIMOTHY M. SMEEDING & LEE RAINWATER, *COMPARING LIVING STANDARDS ACROSS NATIONS: REAL INCOMES AT THE TOP, THE BOTTOM, AND THE MIDDLE* (Social Policy Research Centre, Univ. of New S. Wales, Discussion Paper No. 120, 2002), available at <http://www.sprc.unsw.edu.au/dp/DP120.pdf>.

<sup>529</sup> See Kornhauser, *Fair Income Tax*, *supra* note 109, at 643–55 (discussing numerous surveys and studies).

<sup>530</sup> The Survey was conducted by the Center for Political Studies of the University of Michigan. See NAT'L ELECTION STUDIES, CTR. FOR POLITICAL STUDIES, UNIV. OF MICH., THE NES GUIDE TO PUBLIC OPINION AND ELECTORAL BEHAVIOR, <http://www.umich.edu/~nes/nesguide/nesguide.htm> (last visited Nov. 15, 2004).

<sup>531</sup> See generally LARRY M. BARTELS, HOMER GETS A TAX CUT: INEQUALITY AND PUBLIC POLICY IN THE AMERICAN MIND (Ctr. for the Study of Democratic Politics, Princeton Univ.,

income inequality has increased said they thought that it was a 'bad thing'; most of the rest said they 'haven't thought about' whether it is good or bad, while only about 5% said it was a good thing."<sup>532</sup> Furthermore, most Americans do not view income inequality as a merely natural phenomenon. Slightly more than half believe that unequal access to quality education is an important factor, while slightly less than half believe "unequal effort" is "very important" and many believe discrimination and government policies are important.<sup>533</sup>

Perhaps American distrust of government is the reason that voters do not demand more progressive taxation. Christopher Jencks has observed the following:

Almost everyone who studies the causes of economic inequality agrees that by far the most important reason for the differences between rich democracies is that their governments adopt different economic policies. The fact that the American government makes so little effort to reduce economic inequality may seem surprising in a country where social equality is so important. . . . But while the tenor of American culture may be democratic, Americans are also far more hostile to government than the citizens of other rich democracies. Since egalitarian economic policies require governmental action, they win far less support in the United States than in most other rich democracies.<sup>534</sup>

This might explain skepticism in regard to overtly redistributive policies, but it does not fully explain the apparent apathy toward disproportionate tax cuts for the rich. Do most people really think the rich pay too much in taxes and that they deserve disproportionately large tax cuts? It is doubtful.<sup>535</sup> In the 2002 National Election Study

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Working Paper, 2003), available at <http://www.princeton.edu/~csdp/research/pdfs/homer.pdf> (last modified May 18, 2004).

<sup>532</sup> See *id.* at 7.

<sup>533</sup> See *id.* at 9.

<sup>534</sup> Jencks, *supra* note 528, at 49.

<sup>535</sup> For a contrary view, see Kornhauser, *supra* note 505, at 169. Professor Kornhauser argues that there are "real contradictions within the collective psyche of America." *Id.* She concludes that "[i]t is not only millionaires who want low rates, but also working and middle class people who dream of becoming millionaires in the land of opportunity." *Id.* To the extent this attitude might be important, misperceptions might fuel it. There is evidence that nearly 20% of Americans believe that they are already in the top 1%. See Carol Graham & H. Peyton Young, *Ignorance Fills the Income Gap*, BOSTON GLOBE, June 23, 2003, at A13, available at <http://www.brook.edu/gs/commentary/oped/20030623grahamyoung.htm> (reporting on a Time/CNN poll in October 2000). Likewise, the belief that the

Survey, more than half the respondents said that the rich pay less taxes than they should, whereas less than 15% believed that the rich pay too much.<sup>536</sup> Larry M. Bartels has summarized the views on levels of taxation of the rich and poor from the 2002 National Election Study Survey as follows:

Here, as so often, it is easy to disagree about whether the glass is half full or half empty. Half of the American public thinks that rich people are asked to pay less than they should in federal income taxes—but almost half do not think so. More than 60% agree that government policies have exacerbated economic inequality by helping high-income workers more—but more than a third deny that assertion, and more than 85% say that “some people just don’t work as hard.” More than 40% say the difference in incomes between rich and poor has increased over the past 20 years, and that that is a bad thing—but an even larger proportion either don’t recognize the fact or haven’t thought about whether it is a good thing or a bad thing.

On the other hand, what is pretty clearly absent in these data is any positive popular enthusiasm for economic inequality. Americans may cling to their unrealistic beliefs that they, too, can become wealthy; but in the meantime they do not seem to cherish those who already are. Fewer than 7% say that a larger income gap between the rich and the poor is a good thing (or that a smaller gap is a bad thing). Fewer than 15% say the rich are asked to pay too much in taxes, while three times that many say the poor are asked to pay too much in taxes.<sup>537</sup>

If this is true, then why do so many Americans support the Bush tax cuts? A Harris Poll in June 2003 found that 50% thought the 2003 tax cut was “a good thing,” while 42% said it would help “the rich” a lot and only 11% said it would help “the middle class” a lot. An even more recent survey that asked whether respondents approved or disapproved when they were reminded that “President Bush and Congress have made two major cuts in federal income tax rates” found that 54% ap-

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United States offers great opportunity of income mobility is more mythical than real. *Id.*; see *subra* notes 427–448 and accompanying text.

<sup>536</sup> BARTELS, *supra* note 531, at 10–11.

<sup>537</sup> *Id.*

proved of the tax cuts, while only 37% disapproved.<sup>538</sup> Why do a majority of people approve of tax cuts that increase economic inequality when a majority thinks there is already too much inequality and that the rich do not pay as much in taxes as they ought to?

The obvious possibility is that most voters "just don't get it." It might be that most Americans do not understand that the Bush tax cuts, like most other tax legislation in the past twenty-five years, with the notable exceptions of the Omnibus Budget Reconciliation Acts of 1991 and 1993, have been regressive. This misperception, of course, could simply be one facet of misunderstanding of the tax system as a whole. A study by Joel Slemrod has found that voters support various tax proposals because of widespread misperceptions.<sup>539</sup> For example, there is widespread support for a flat rate tax or a national sales tax, both of which would be highly regressive moves, because most voters doubt that the current system actually is progressive. Thus, they believe the rich would pay more, not less, under a flat-rate tax or a national sales tax. Similarly, overwhelming popular support for repeal of the estate tax appears to be linked to the misperception held by nearly 50% of the respondents in the study that most families have to pay the tax.<sup>540</sup>

Professor Slemrod also found that lack of sophistication, represented by lower educational achievement, increased the chances of misperceiving a move to a retail sales tax as increasing progressivity. This is consistent with recent findings—contravening the conventional wisdom that less sophisticated individuals vote their own pocketbook—that less sophisticated voters cannot make the necessary associative linkages between government policies and their own pocketbooks that more sophisticated individuals can make.<sup>541</sup> Thus, particularly in presidential elections, less sophisticated voters focus on the economy as a whole in assessing candidates, whereas more sophisticated voters are able to make the necessary associative linkages between government policies and their own pocketbooks. Extrapolating, this might mean that relatively less sophisticated voters, who generally will be found below the top of the income pyramid, simply do not understand who

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<sup>538</sup> *Id.* at 3.

<sup>539</sup> Joel Slemrod, *The Role of Misperceptions in Support For Regressive Tax Reform* 2 (Nov. 10, 2003), available at [http://www.brookings.edu/dybdocroot/comm/events/20031216\\_slemrod.pdf](http://www.brookings.edu/dybdocroot/comm/events/20031216_slemrod.pdf).

<sup>540</sup> For other studies showing similar widespread mistaken beliefs, see BARTELS, *supra* note 531, at 14–18.

<sup>541</sup> Brad T. Gomez & J. Matthew Wilson, *Political Sophistication and Economic Voting in the American Electorate: A Thesis of Heterogeneous Attribution*, 45 AM. J. POL. SCI. 899, 899–90 (2001).

benefits from the tax cuts. For them, tax cuts are tax cuts and they think everyone benefits.

Evidence from the 2002 National Election Study Survey supports the idea that much of the populace is simply clueless about the tax cuts. Depending on how the question was asked, that is, support for the tax cuts Congress passed or support for the tax cuts President Bush signed, either 35% or 45% of respondents answered that they “haven’t thought about it.”<sup>542</sup> Public opinion about the tax cuts does not appear to be particularly well informed.

This lack of understanding—or disinterest—in the effects of the Bush tax cuts is just one aspect of broad based ignorance about the tax system. A 2003 survey of views on taxes sponsored by National Public Radio, the Kaiser Foundation, and the John F. Kennedy School of Government revealed the following: (1) 34% of respondents answered that they did not know whether they paid more in income tax or Social Security and Medicare tax, and the answers of most of the rest were wrong; (2) 28% did not know whether they were eligible for the earned income tax credit; (3) 42% answered that they did not know whether taxes are higher in the United States than in Western Europe; (4) 61% had not heard of President Bush’s then recently announced proposal to exempt dividends from taxation; (5) 48% had no opinion on whether the 2001 tax cuts should be accelerated; (6) 60% had no opinion on whether the tax cuts should be allowed to expire in 2011 or be made permanent; and (7) 41% did not know whether accelerating the cuts and making them permanent would primarily help high-income, middle-income, or lower-income people.<sup>543</sup> All of this indicates that although people are generally supportive of tax cuts in the abstract, they really do not know exactly what—or whose interests—they are supporting. The public in general is uninformed about the tax system, and much of what it thinks it knows is just plain wrong.

If people know so little about the tax system, how do they decide whether or not they favor or oppose tax cuts? Professor Bartels has advanced the proposition that their opinions are based on “simple-minded and sometimes misguided considerations of self-interest.”<sup>544</sup> His analysis of the data from the 2002 National Election Study Survey shows, for example, that an individual’s view that one’s own federal

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<sup>542</sup> BARTELS, *supra* note 531, at 14–18.

<sup>543</sup> *Id.* at 19–20.

<sup>544</sup> *Id.* at 21.

income taxes were "too high" was a much better predictor of support for repeal of the estate tax than was a person's view with respect to whether or not the rich pay too much or too little in taxes.<sup>545</sup> Furthermore, the view that one's own federal income taxes were too high was a stronger predictor of support for repeal of the estate tax among lower- and middle-income classes—the groups least likely ever to be subject to the estate tax, even though most of them mistakenly believed that they would be subject to it—than among those in the top third of the income distribution. The same correlation applies with respect to support for the 2001 income tax cuts. An individual's view that one's own taxes were too high was a far more significant predictor of support for the tax cuts than was a person's view with respect to whether or not the rich or the poor pay too much or too little in taxes.<sup>546</sup> In this case, however, there was at least some logical reason for those who thought their own taxes were too high to support the tax cuts. Perhaps the most striking finding was that including spending preferences, ideology, and party identification in the analyses along with attitude regarding one's own tax burdens completely eliminated the impact on support for the tax cut of attitudes about the tax burden of the rich. From this, Professor Bartels concludes that "public support for the Bush tax cuts derives in considerable part from unenlightened considerations of self-interest on the part of people who do not recognize the implications of Bush's policies for their own economic well-being or their broader political values."<sup>547</sup> In other words, they just do not get it!

One last factor in why the middle class just does not get it, may be the rhetoric in the political arena. To put it bluntly, the average voter has been deceived by the politicians seeking tax cuts for the wealthy. The political rhetoric of tax cuts always focuses on tax cuts for the struggling middle class family. The tax cuts that are delivered are any-

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<sup>545</sup> *Id.* at 22. Although Professor Bartels discusses the fact that most Americans do not understand that they have a greater payroll tax burden than income tax burden, he does not directly discuss the fact that working and middle class people tend to measure their income tax burden with reference to withholding, which includes both income taxes and payroll taxes. See Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by the Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 58–59 (1990).

<sup>546</sup> Although ideology—identification as a conservative or as a Republican—also influenced attitudes, the view that one's own taxes were too high remained a powerful predictor after controlling for these other factors. Whether or not the tax cut was described as being associated with Congress or President Bush also influenced attitudes. If the tax cuts were associated with President Bush, rather than Congress, views of one's own tax burden became an even stronger predictor of support.

<sup>547</sup> BARTELS, *supra* note 531, at 29.

thing but that. This aspect of the class warfare of the past twenty years has been seriously explored by a handful of political analysts and investigative journalists over the past two decades.

Prominent political analyst Kevin Phillips observed over a decade ago that, the 1980s were “an era of tax *deception* . . . where the average American family was concerned.”<sup>548</sup> As has been demonstrated, Phillips was right. Despite all of the rhetoric of tax reduction, families in the middle quintiles saw their share of the tax burden rise even as their share of income was declining. Apart from the impact at the very bottom, resulting from expansion of the earned income tax credit,<sup>549</sup> only families in the top 5% saw their share of income rise more steeply than their share of taxes, and only families in the top 1% saw it happen dramatically.

Investigative journalists Donald Barlett and James Steele reached a similar conclusion.<sup>550</sup> They describe the process as the “Capital Hill Magic Show.”<sup>551</sup> Politicians provide very modest tax relief for the poor and middle class, on which they focus their public pronouncements, while quietly delivering significant tax relief to the wealthy. They make the further point that proponents of tax relief for the wealthy—or opponents of increasing taxes on the wealthy—also respond with the cry that those on the other side of the issue are engaged in “class warfare.” Barlett and Steele point out the following:

They were right about one thing. There has been class warfare. But it didn't start with the introduction of the Omnibus Budget Reconciliation Act of 1993. Nor was it directed against the rich. In truth it began quietly in the 1960s, and continued through the 1970s and 1980s. And the target was the middle class.<sup>552</sup>

In their analysis, Barlett and Steele compare the public statements of politicians of both political parties with the actuality of numerous tax acts, demonstrating the differences.

William Greider has similarly analyzed the politics of the tax legislative process in the 1980s and early 1990s, describing it as “bait and

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<sup>548</sup> KEVIN PHILLIPS, *BOILING POINT: DEMOCRATS, REPUBLICANS, AND THE DECLINE OF MIDDLE CLASS PROSPERITY* 103 (1993).

<sup>549</sup> See *supra* note 82 and accompanying text.

<sup>550</sup> DONALD L. BARLETT & JAMES B. STEELE, *AMERICA: WHO REALLY PAYS THE TAXES?* 58–94 (1994).

<sup>551</sup> *Id.* at 73.

<sup>552</sup> *Id.* at 94.



switch," while emphasizing that Democrats have participated equally with the Republicans in this gambit.<sup>553</sup> Greider concludes that politicians of both parties have responded to the desire of the "economic elites" for reduction of their taxes, while engaging in political rhetoric portraying their actions as in the broad public interest and beneficial to all. He notes that "[t]he Reagan tax cutting had begun with the Great Communicator's paeans to the energies of the everyday working people."<sup>554</sup> The great bait and switch was the 1983 legislation increasing payroll taxes dramatically. Any benefit from income tax cuts for the middle class was offset by the increased payroll taxes. Greider attributes the Democrats' penchant for joining Republicans in this process as emanating from the fact that campaign funds came from the economic elite and lower-income voters increasingly failed to participate in the political process.

More recently, David Cay Johnston exposed how "this policy of taxing the poor and the middle class to finance tax cuts for the super-rich" did not end with the changes in the 1980s, but continued through the 1990s and into the early years of the twenty-first century.<sup>555</sup> Johnston's analysis focused primarily on tax administration, rather than on the political rhetoric of campaigns for tax legislation, but he did not ignore the politics of the tax legislative process. He examines in detail the importance of changing the nomenclature to "death tax" for the political campaign behind the drive to repeal the estate tax. This new terminology helped convince the populace that the estate tax applied to everyone and that their taxes were being reduced rather than only those of the super-rich.<sup>556</sup> Although the drive to repeal the estate tax was primarily a Republican goal, in which some Democrats joined, more broadly, Johnston also finds little real difference between the two political parties in regard to the general propensity to deliver large tax cuts to the rich cloaked in the rhetoric of tax cuts for the masses. Johnston, too, chronicles the great deception of the vast expansion of the payroll tax beginning in 1983 that has in fact been used to fund general expenditures and which contributed significantly to the transitory "surplus" of the later 1990s that was "returned" to the taxpayers—mostly to the super-rich taxpayers—

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<sup>553</sup> WILLIAM GREIDER, *WHO WILL TELL THE PEOPLE?: THE BETRAYAL OF AMERICAN DEMOCRACY* 79–80 (1992).

<sup>554</sup> *Id.* at 89.

<sup>555</sup> JOHNSTON, *supra* note 233, at 18–19.

<sup>556</sup> *Id.* at 71–91.

through the Bush tax cuts.<sup>557</sup> Johnston describes the combination of payroll tax increases on low- and middle-income earners and income tax cuts skewed to high-income earners as follows:

[A] massive redistribution program right out of George Orwell's *Animal Farm*, where the ruling pigs declared that some animals were more equal than others. That teachers and cops and truck drivers and clerks pay extra Social Security taxes so the rich can pay less income tax is an economy Orwell would have understood.<sup>558</sup>

This viewpoint of the politics of taxation also is shared by some noted economists, including Nobel Prize-winning economist Joseph E. Stiglitz. He described the political process surrounding the 1997 reduction in long-term capital gains rates from 28% to 20% as follows:

Greed on the part of Wall Street and the real estate industry, wrong-headed accounting, a conservative political establishment perfectly willing to use this accounting for their long-run goal of downsizing the government, combined with more liberal politicians who wanted to put themselves in good graces with sources of campaign finance, all worked to pass the capital gains tax cut of 1997, one of the most regressive tax cuts in American history (with strong competition to come four years later from Bush II). But there was one more ingredient: Not only did many of those forces succeed in convincing America that deregulation, however executed, would be of benefit to all Americans: they also convinced middle-class voters, and even poorer Americans that they too would benefit from the capital gains tax cut. The capital gains tax cut was politically popular. Everybody has their shares (though most of their shares were held in accounts in which the accumulations were, in any case, tax free). They would do everything they could to protect these little pieces of capitalism against the rapacious government. . . . No matter that the tax cut saved the upper-income taxpayer \$100 for every \$5 that the middle-income taxpayer was spared. They were all in

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<sup>557</sup> *Id.* at 117–28.

<sup>558</sup> *Id.* at 125.

the same boat, all working to save themselves from those who would take—and supposedly waste—their money.<sup>559</sup>

Professor Stiglitz expressed great concern about the values that both the result and the process represented—reducing capital gains rates and increasing taxes on wages (through the payroll tax) taught “[t]hat it is far better to make your living by speculation than by any other means.”<sup>560</sup> And the process was equally bad; by talking about incentives that would result from the capital gains tax cut “when most of the tax giveaways had no incentive effect at all, we were also teaching our young people another lesson in political hypocrisy.”<sup>561</sup>

Focusing mainly on the Bush tax cuts, Paul Krugman has described the political process as “The Tax-Cut Con.”<sup>562</sup> In a *New York Times Magazine* article bearing that title Professor Krugman observed that the current Bush administration has been remarkably successful in putting a “populist gloss on tax cuts so skewed to the rich.” Part of that “con” was “an insistent marketing campaign [that] has convinced many Americans that they are overtaxed.” But the public pronouncement of the reasons for the tax cuts constantly shifted and Professor Krugman describes the 2003 tax cuts, particularly those focused on dividends and capital gains, as achieved “through a combination of hardball politics, deceptive budget arithmetic and systematic misrepresentation of who benefits.” Clearly, the “tax deception” that Kevin Phillips so accurately described as characterizing the 1980s has continued unabated through the 1990s and into the twenty-first century.

### VIII. QUELLING THE MATTHEW EFFECT

The facts are incontrovertible. Very few Americans have a great deal of the economic wealth of the country and very many have very little of the economic wealth of the country. And the Matthew Effect continues to control the distribution of increasing aggregate national income. The rich are getting much richer and the poor and the middle class are relatively stagnant. The United States suffers greater economic inequality than any other major industrialized democracy, and that inequality is increasing. And we cannot validly defend this situation factually by claiming that even our poor are better off than the poor in other industrialized democracies. They are not.

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<sup>559</sup> STIGLITZ, *supra* note 4, at 176–77.

<sup>560</sup> *Id.* at 178.

<sup>561</sup> *Id.*

<sup>562</sup> Paul Krugman, *The Tax-Cut Con*, N.Y. TIMES, Sept. 14, 2003, § 6 (Magazine), at 54.

Our tax system, although somewhat redistributive, is unfair. It taxes the rich, particularly the super-rich, too lightly relative to everyone else. The income tax is progressive only up to the point of slightly more than \$300,000 of annual income.<sup>563</sup> The income tax is not sufficiently progressive, however, to offset the impact of regressive flat-rate payroll taxes, which are the most significant tax for most Americans, but which largely do not apply to most of the income of the rich. At the top of the income pyramid, the progressivity is largely nonexistent. We make no attempt to distinguish between the near rich, the rich, and the super-rich. For all three groups, there is only one normal marginal rate—35%—and much of the income of the super-rich—that which is realized in the form of dividends and capital gains—is taxed at only 15%. For the super-rich, the income tax is essentially either a flat rate tax or a regressive tax. As a result, the tax system fails adequately to take into account the diminishing marginal utility of money, fails to allocate tax burdens according to ability to pay, and fails to effect significant redistribution in the face of the greatest economic inequality among the major industrialized democracies of the world.

Furthermore, the situation is getting worse. The incomes and wealth of the super-rich are growing far more rapidly than the incomes and wealth of everyone else, including the merely rich. For that matter, in real terms, the before-tax real incomes of many in the base of the income pyramid have stagnated or even fallen. A fair-minded person would think that the reaction would be to increase the progressivity of the tax system by increasing taxes on the rich. Instead, with the exception of two tax acts in the 1990s, over the past twenty-five years the United States has been systematically reducing taxes on the rich by magnitudes that dwarf any tax relief for the middle class. The Matthew Effect has prevailed in the political arena. In tax act after tax act, the burden of aggregate taxation has been shifted down (or to future generations through tax-cut-induced deficits). It is only the extraordinary rate of growth of the before-tax share of income realized by the rich that causes their share of total taxes paid to increase, allowing the effects of tax legislation on tax burdens to be hidden from voters.

Tax cut mania is fueled by erroneous perceptions that the United States is a high tax nation, when the facts are exactly the opposite. The United States has one the very lowest tax burdens of all of the OECD countries, and by a wide margin when compared to Western

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<sup>563</sup> For 2005, the 35% bracket begins at \$326,450 of taxable income, whether married filing a joint return or single. Rev. Proc. 2004-71, § 3.01, 2004-50 I.R.B. 970.

European countries.<sup>564</sup> The spurious argument that our taxes are so high that they create disincentives to save and to work and that tax cuts for the rich will lead to bounteous economic growth in which all will share, have been trotted out again and again by tax cut proponents without any real challenge in the public policy debates, even though the empirical data prove the claim to be false. The significant empirical evidence that economic inequality impairs economic growth has been ignored entirely.

The result of this frenzy of tax cuts for the rich has been to fuel a massive federal deficit that has been exacerbated by, even though not wholly attributable to, tax cuts for the rich at the same time that the United States invests too little in the infrastructure of human capital. We fail to provide higher quality education and healthcare for tens of millions of poor and middle-class Americans who would be far more productive with greater public investment in education and healthcare. But we claim that we cannot afford to make these investments because of the budget deficit. To be sure, the budget deficit is a problem, a serious problem. Eventually the budget deficit will interfere with economic growth and, as it leads to the United States becoming even more of a debtor nation, it will reduce the living standards of Americans generally.

The American people want government services in the form of education and healthcare, as well as highways, police protection, national security, and all of the other public infrastructure necessary to create a prosperous industrialized state. Yet the American people have supported tax cuts that in fact go disproportionately to the wealthy, while spending on infrastructure other than national security languishes.

Millions of citizens say that the federal government should spend more on a wide variety of programs, that the rich are asked to pay too little in taxes, and that growing economic inequality is a bad thing—but simultaneously support policies whose main effects will be to reduce the tax burden of the rich, constrain funding for government programs, and exacerbate growing economic inequality.<sup>565</sup>

How does this come to pass? Collectively, we appear to suffer from cognitive dissonance. It is the responsibility of our government to get it right—to do the right thing, not the popular thing. What

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<sup>564</sup> See *ORG. FOR ECON. CO-OPERATION & DEV.*, *supra* note 333, at tbl.A.

<sup>565</sup> *BARTELS*, *supra* note 531, at 29.

should be done is obvious. At the very least we need to re-impose higher tax rates on the super-rich. Steep progressivity through most of the income pyramid is not nearly as important as it is at the top. It is in the top 1% where the greatest disparities are found.

The top 1% is strikingly different from the 95th percentile, even though the bottom of the top 1% actually more nearly resembles the 96th through 99th percentiles than it does the top of the top 1%. The differences in the top 1% as a whole are enormously striking. The same is true for each income group in increasingly smaller cohorts within the top 1%. Each cohort is closer to those below it than to those ahead of it. And the peak of the pyramid is enormously different. The 6836 income tax returns that reported AGI of \$10 million or more for 2001—a mere 0.001% of all filers, reported 2.84% of all income, over twice as much as reported by the 12,266 filers in the \$5 million to \$10 million cohort, and more than the 52,157 filers in the \$2.5 million to \$5 million cohort.<sup>566</sup> The increasing differences, not only in dollars but in multiples of income, are sufficient to warrant significantly increasing steepness in the graduation of rates.

The highest marginal income tax rate faced by the top of the income pyramid—the top 1%—is 35%. That 35% rate applies to a marginal dollar of income whether it is the \$500,000th or the \$5,000,001st. Furthermore, due to the preferential rates for capital gains and dividends and the concentration of those types of income at the top of the income pyramid, those at the very top often face marginal, and sometimes average, rates lower than that and lower than most taxpayers in lower cohorts, who generally have little or no capital gains or dividend income. Until the mid-1960s, the income tax system was largely flat rate or mildly progressive for the masses, with steeply progressive surtaxes on a relatively small percentage of the population. Today, the federal tax system is progressive for the masses, but progressivity tapers off at the top of the income pyramid.

Forty years ago, the top of the income pyramid faced dramatically higher tax rates. In 1962, the top 0.5% of filers, by AGI class, was subject to marginal tax rates of 50% or more. Slightly less than 4% of filers were in marginal tax brackets higher than 50%.<sup>567</sup> Even after the 1964 rate reduction, high-income taxpayers continued to face marginal rates of up to 70%. In 2001 dollars, applying the 1965 rate schedule, the

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<sup>566</sup> David Campbell & Michael Parisi, Internal Revenue Serv., *Individual Income Tax Returns, 2001*, 23 STATISTICS OF INCOME BULL. 8, 23 tbl.1 (Fall 2003), available at <http://www.irs.gov/pub/irs-soi/01indtr.pdf>.

<sup>567</sup> Derived from INTERNAL REVENUE SERV., *supra* note 111, at 110–13 tbl.20.

threshold for the 50% bracket for a joint return would be slightly less than \$250,000, an income now in the 31% bracket.<sup>568</sup> The threshold for the 60% bracket would be approximately \$493,000, and the threshold for the 70% bracket would be approximately \$1,121,000.<sup>569</sup> The mid-1960s rate schedules thus took into account the differentials just below the top of the income pyramid better than any rate structure we have had since.<sup>570</sup> Today, however, the income differentials for those whose income exceeds \$500,000 are extraordinary compared with the halcyon days of the 1960s. Although we must be concerned with declining taxes on the near rich and wannabes just below the near rich, it is the true top with which we must be most concerned.

For 2001, the income cohorts above \$500,000 represent slightly more than 0.4% of all returns, and they reported over 13% of AGI. The IRS has recently revised its Statistics of Income reporting, which previously had top-coded data at AGI of \$1 million to break out cohorts between \$1 million and \$1.5 million, \$1.5 million and \$2 million, \$2 million and \$5 million, \$5 million and \$10 million, and over \$10 million.<sup>571</sup> These income cohorts represent the top 0.15% of returns, and they reported over 9% of total AGI. These are the income cohorts with which we should be concerned. These are the income cohorts that have seen their income taxes slashed while payroll taxes have steadily increased. These are the income cohorts whose taxes should be increased dramatically.

Even though the budget might not be balanced by increasing taxes on the super-rich,<sup>572</sup> both the tax system and the after-tax distribution

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<sup>568</sup> Derived from I.R.C. § 1, as in effect for 1965, and U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2002, at 449 tbl.680 (2003).

<sup>569</sup> In 1965, for married couples filing a joint return, the threshold for the 50% bracket was \$44,000 and the threshold for the 70% bracket was \$200,000.

<sup>570</sup> See generally Marc Linder, *I Like Ike: Bringing Back Eisenhower-Era Progressive Taxation*, 67 TAX NOTES 833 (1995).

<sup>571</sup> See Campbell & Parisi, *supra* note 566, at 8 tbl.1.

<sup>572</sup> It is possible that the budget could be balanced by repealing the 2001 and 2003 tax cuts for taxpayers with taxable incomes exceeding \$200,000. According to Treasury Department estimates, repeal of the reduction of the 39.6% marginal bracket to 35% and of the 36% marginal bracket to 33% would increase revenues by \$171.9 billion if the remainder of the 2001 and 2003 Acts were made permanent and by \$100.3 billion if they were allowed to sunset. Repeal of the reduction of rates for dividends and capital gains would increase revenues by \$204.5 billion if the remainder of the 2001 and 2003 Acts were permanently extended, whereas repeal of the rate reduction for dividends and capital gains only with respect to taxpayers with taxable incomes exceeding \$200,000 would increase revenues by \$102.4 billion. Press Release, Office of Pub. Affairs, Dep't of the Treasury, (JS-1247) (Mar. 22, 2004), <http://www.ustreas.gov/press/releases/js1247.htm> (last visited Nov. 15, 2004).

of incomes will be fairer if marginal rates on incomes above \$500,000 are increased. As incomes increase above \$1 million, marginal tax rates should continue to increase. At the very least, each of the income cohorts identified in the Statistics of Income data ought to be subjected to increasingly higher graduated rates. Higher marginal rates should apply to incomes that exceed \$1.5 million, compared to those that exceed \$1 million but do not exceed \$1.5 million. The exact width of the rate brackets can be determined another day. But a reasonable starting point would be to increase rates every \$500,000. And as incomes move above \$10 million, there is no reason to stop at a 50% marginal rate. There was nothing wrong with the top end of the 1950s rate schedules if the bracket thresholds are adjusted to modern income levels.

One aspect of 1950s taxation that still lives in the tax system must be eliminated to establish just tax rates. The preferential rate for capital gains, and its offspring, the preferential rate for dividends, must be eliminated.<sup>573</sup> When thoughtfully analyzed, the capital gains preference never has been justifiable as part of an income tax.<sup>574</sup> The newly enacted preferential rate for dividends is a poorly designed partial substitute for corporate tax integration. If corporate integration is desirable—which might not be true with respect to publicly held corporations<sup>575</sup>—a credit imputation system is a far superior alternative. A credit imputation system results in corporate income that is distributed being taxed at the shareholder's marginal rate, whatever it might be.<sup>576</sup> Capital gains and dividend income are too highly concentrated

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<sup>573</sup> To the extent "bunching" is a problem, it can and should be eliminated through an averaging rule along the lines of former I.R.C. §§ 1301–1305, which were repealed by the 1986 Act. Unlike under those rules, however, there probably should be long-term averaging for extraordinarily large gains on assets held for many years. For example, capital gains in excess of \$1 million—or some lesser amount if thought appropriate on policy and administrative convenience grounds—on a single asset (or block of stock) might be averaged over the holding period of the asset. For an even more comprehensive income averaging proposal that might be worth considering, see generally William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 L. & CONTEMP. PROB. 736 (1969).

<sup>574</sup> See, e.g., Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Take Care of Itself*, 50 WASH. & LEE L. REV. 459, 470–73 (1993).

<sup>575</sup> See generally Reuven S. Avi-Yonah, *Back to the 1930s: The Shaky Case Against Corporate Integration*, 97 TAX NOTES 1599 (2002); REUVEN S. AVI-YONAH, *supra* note 504; Herwig J. Schlunk, *Double Taxation: The Unappreciated Ideal*, 102 TAX NOTES 893 (2004); Herwig J. Schlunk, *How I Learned to Stop Worrying and Love Double Taxation*, 79 NOTRE DAME L. REV. 127 (2003).

<sup>576</sup> For a description of a credit-imputation system for integrating the corporate and shareholder taxes on corporate earnings, see DEP'T OF THE TREASURY, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE* 95–106 (1992), available at <http://www.treas.gov/offices/tax-policy/library/integration-paper/integration.pdf>.



at the top of the income pyramid and constitute too high a percentage of the income of the super-rich to achieve just tax rates and a just distribution of after-tax income if these income items continue to be taxed at preferential rates.<sup>577</sup> The ordinary income rate schedule of I.R.C. § 1 cannot carry the entire burden.

### CONCLUSION

It is time to restore steep graduated progressivity at the very top of the income pyramid. It is time to eliminate the capital gains preference. It is time to lift the ceiling on payroll taxes<sup>578</sup> and return payroll taxes to a pay-as-you-go basis, while reducing the rates—or, even better, it is time to repeal the payroll taxes and raise the revenue for Social Security and Medicare through the progressive income tax.<sup>579</sup> It is time to cease the foolish drive to repeal the estate tax and preserve its important antidynastic function.<sup>580</sup> It is time to reverse the Matthew Effect. The critical question is, will we do it in time to avoid the corrosive effects on American society and democracy of the ever-increasing concentration of economic well being? As President Franklin D. Roosevelt stated in his second inaugural address, "The test of our progress is not whether we add more to the abundance of those who have much; it is whether we provide enough for those who have too little."<sup>581</sup>

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<sup>577</sup> See *supra* notes 563–576 and accompanying text.

<sup>578</sup> See Graetz, *supra* note 127, at 868–73.

<sup>579</sup> The original design of the Social Security system did not contemplate that it would be funded entirely out of payroll taxes. See Dilley, *supra* note 131, at 1006–07 (citing BROWN, *supra* note 134, at 44–56) (J. Douglas Brown was the chair of the 1937–1938 Advisory Council on Social Security). See generally Geier, *supra* note 129 (suggesting that workers be allowed a refundable income tax credit for a portion of payroll taxes paid, with Social Security benefits fully includable in gross income, and with medical care received in kind excludable).

<sup>580</sup> This does not necessarily mean that the exemption thresholds should not be raised, and perhaps the exemption level to some extent should be a function of the number of beneficiaries among whom the estate is divided. That is a question for another day. But there is no justification for not heavily taxing large estates, for example, more than \$5 million.

<sup>581</sup> Franklin D. Roosevelt, Second Inaugural Address (Jan. 20, 1937), *reprinted in* 3 VITAL SPEECHES OF THE DAY 227 (1937).